INDIAN FEDERAL FINANCE

By

B. R. MISRA
M.A., PH.D. (LOND.), D.SC. (ECON.) (LOND.)
Professor and Head of the Department of Applied Economics and Commerce, Patna University.

WITH A FOREWORD BY

VERA ANSTEY, D.SC. (ECON.)

ORIENT LONGMANS LTD.
BOMBAY - CALCUTTA - MADRAS

ORIENT LONGMANS LTD.

17 Chittaranjan Avenue, Calcutta 13
Nicol Road, Ballard Estate, Bombay 1
36a Mount Road, Madras 2
17 Nazimuddin Road, Dacca
Kanson House, Delhi Ajmeri Gate Scheme, New Delhi
16/70, Sanyasiraju Street, Gandhinagar,
Vijayawada-2

LONGMANS, GREEN AND CO. LTD.

6 & 7 Clifford Street, London W. 1
531 Little Collins Street, Melbourne C. 1
Boston House, Strand Street, Cape Town

LONGMANS, GREEN AND CO. INC.
55 Fifth Avenue, New York 3

LONGMANS, GREEN AND CO.
215 Victoria Street, Toronto 1

Original edition (O.U.P.), 1942
Revised edition, May 1954

Printed in India
By K. C. Bose at Binani Printers Ltd.
38, Strand Road, Calcutta-1

FOREWORD

In 1942 Professor B. R. Misra published the first edition of his study of the development and problems of public finance in India—which then, as now, is of great topical as well as of permanent academic interest—under the title *Indian Provincial Finance, 1919-1939*. The book earned well-merited success, and he has now completed an up-to-date revision. Indeed this new edition is in reality far more than a 'revision', as the revolutionary political, economic and financial changes in India arising out of the second world war, post-war problems, the partition of 1947, the coming of Independence and the new Constitution of 1950, have fundamentally altered both the background and the problems of Public Finance in India. Even the title has become outmoded: there are now no 'Provinces' in India and the former Indian States have become absorbed into the Indian Union, so that Professor Misra has correctly renamed his work *Indian Federal Finance*.

The new Constitution has formally recognised the altered and enlarged scope of federal finance in India by (a) removing the remnants of the constitutional limitations under which the financial system worked under the Act of 1935; (b) extending, mainly through its new planning authorities and policies, the economic functions of the Centre and the States; and (c) fully integrating the former Indian States into the Union.[1] Nevertheless it remains true, as I pointed out in my foreword to the first edition, that public administration, of which public finance is the very core, necessarily takes a pyramidal form. The base consists of local administration—entrusted to local authorities, such as the parish (in England) or the *panchayat* (in India)—upon which rests district administration, which in its turn supports (in India) what was formerly provincial, now state, administration, and finally

[1] Cf. Professor Misra's *Economic Aspects of the Indian Constitution* p. 69, Orient Longmans, 1952.

federal administration. The strength of the whole structure, especially with the extension of governmental economic functions and the increased and increasing reliance upon planning, depends largely upon the soundness of its foundations. Hence the progressive realization of the ideals of the new Constitution—which may perhaps be shortly summarized as 'political and economic democracy'—depends ultimately upon the development of local self-government, and upon the proper administrative (including financial) co-ordination of the functions and powers of the whole series of authorities. But it is precisely in these spheres that there has, in India, been great weakness in the pact. Local administration and finance are still, despite recent efforts, in an embryonic stage, and until progress is made in this respect it is difficult to see how the state or federal financial systems can be made into effective organs for the implementation of economic planning, and the realization of the ideals of economic development and modernization and of a decent standard of life for all, laid down in the Constitution of 1950. The reform and development of the finances and functions of the minor authorities therefore form a necessary preliminary to the creation of a sound and progressive future financial programme for India as a whole.

Professor Misra's study which includes within its purview the history of the development of the present financial structure, local finance, the financial relations between the states and the centre, and the need for greater co-ordination, throws much light upon the weak spots in the existing system and on the principles which should guide financial development. These principles are analyzed in relation to welfare in the broadest sense of the term, and not merely in relation to formal financial considerations. Above all it can be said that Professor Misra has depicted the complicated story of the development of the present financial system and has analyzed the outstanding relevant problems not in order to promote the programme of a particular party or group of interests, but from a broad and detached—*i.e.* a truly independent and scientific—point of view.

My pleasure in introducing this new edition, as well as the first edition, to the public is enhanced by the fact that it was my

duty to act as Professor Misra's supervisor during his two years' residence in London whilst writing the original volume. I have not been concerned with the preparation of the new edition, except in so far as the author has kept me informed of his intentions and the progress and form of the new work, but I should like to repeat how much I was impressed, when Professor Misra was working at the London School of Economics, by his untiring pursuit of knowledge, his deep desire to consider all aspects of his chosen theme, and his independence of thought. His conclusions and suggestions will, no doubt, provoke criticism and controversy, but it can at least be said that they represent the honest judgments of a well-informed student of India's economic and financial problems.

London School of Economics,
August 19, 1952.

VERA ANSTEY

PREFACE

The present work is a successor to my *Indian Provincial Finance* published in 1942. It incorporates chapters II, III, IV and V of that work.

The object of this work is essentially to trace the growth of federal finance in India and to state its present position. With this object a brief historical survey together with a detailed account of the Montagu-Chelmsford Reforms and the Meston Settlement is given at the outset. This has been followed by an account of the Government of India Act, 1935. Next, the main features of the financial system under the Constitution are described. In chapters VIII and IX the present position of the Union and State finances is stated. *Lastly,* the various problems of local taxation are examined and the need for co-ordinating the tax policy of the State Governments and Local Authorities is pointed out.

My *Indian Provincial Finance* was written under the supervision of Dr. Vera Anstey of the London School of Economics under whom I had the pleasure to work during 1937-39. Dr. Vera Anstey has kindly again re-introduced the work to the public by writing the Foreword to the present work. For this kindness, my thanks are due to her.

Finally, I must also thank my publishers, Orient Longmans Ltd., for the care they have bestowed on the preparation of the MSS. for the press.

Patna University
January 1, 1953

B. R. MISRA

CONTENTS

I

INTRODUCTORY

§1. *POVERTY AMIDST PLENTY*

Causes of 'Arrested' Economic Development

'The most arresting fact about India is that her soil is rich and her people poor.'[1] Here is a country with rich natural resources but the poverty of its people is a byword throughout the world. This paradox of Indian economic life is principally due to over-population, lower production, agricultural and industrial, and the absence of a more equitable tax system. The discussion of the first two topics lies outside the scope of the work. Nevertheless, a passing reference to them is essential.

Population in India is rapidly increasing; malaria, hook-worm, smallpox and plague drain the prosperity of the country. The pressure of population on the land has considerably increased with the result that in many tracts of India the majority of the holdings are below the economic size. In the absence of proper manuring facilities and rotation of crops the practice of a highly intensive cultivation has turned agriculture into robbery of the soil. The general prosperity of India, upon which alone a sound budgetary policy can be framed, can never be substantially increased so long as an increase in income is absorbed by an increase in population. 'The population problem lies at the root of the whole question of India's economic future, and it is useless to try to bilk the fact.'[2]

Again, 'the financial problem has undoubtedly been an important factor in the arrested economic development of India.'[3] The reason is not far to seek. On the one hand, a constructive social and economic policy followed by the Government is everywhere creating greater demands upon the public purse; on the

[1] Darling, M.L., *The Punjab Peasant in Prosperity and Debt.* Oxford University Press, 1932. p. 67.
[2] Anstey, V., *The Economic Development of India* (Longmans) 3rd edition. 1936, p. 475. The references throughout this work are to this edition.
[3] Ibid. p 476.

other hand the inadequate fiscal basis (largely due to lower production) and the fiscal machinery in raising the revenue from a population mostly consisting of poverty-stricken masses, is getting out of gear. Thus at both ends the pressure is felt. To maintain the type of expensive administration introduced by the British Government, expenditures are fast growing and the old forms of revenue are proving oppressive, inadequate or unsuitable. Hence the discontent with the financial policy of the Government is growing apace. And since the expenditure of the State Government and local authorities affects more intimately the life of an average citizen than that of the Union Government, the problems of State and local revenues are becoming increasingly difficult and important.

The States of India

It would be desirable, before entering upon any financial description or discussion, to give a brief account of the main features of the economic life of the States into which India is now divided. The description of the economic conditions, State by State, would involve repetition. Hence a view of India as a whole may be of advantage.

India is now made up of States classified in Four Schedules as follows :—

PART A States

Names of States	Names of corresponding Provinces under Government of India Act 1935
1. Assam	Assam
2. Bihar	Bihar
3. Bombay	Bombay
4. Madhya Pradesh	The Central Provinces & Berar
5. Madras	Madras
6. Orissa	Orissa
7. Punjab	Punjab
8. Uttar Pradesh	The United Provinces
9. West Bengal	Bengal

PART B States

1. Hyderabad
2. Jammu and Kashmir
3. Madhya Bharat
4. Mysore
5. Patiala and East Punjab States Union
6. Rajasthan
7. Saurashtra
8. Travancore-Cochin

PART C States

1. Ajmer
2. Bhopal
3. Bilaspur
4. Coorg
5. Delhi
6. Himachal Pradesh
7. Kutch
8. Manipur
9. Tripura
10. Vindhya Pradesh

PART D States

The Andaman and Nicobar Islands

The above classification of the States is of importance in matters relating to the distribution of revenues and assignment of grants between the Union and the States. To this we come in a later chapter.

Area and Population

The total area covered by India amounts to 1,249,640 square miles which is a little more than three-fourths of the total area of undivided India.[1] The area and population of some of the States is shown in the following table :[2]

State	Area in square miles	Population	Density of Population Per Sq. mile
India	1,269,640	356,829,485	281.048
Uttar Pradesh	113,409	63,215,742	557.414
Bihar	70,330	40,225,947	571.960
Orissa	60,136	14,645,946	243.547
West Bengal	30,775	24,810,308	806.184
Assam	85,012	9,043,707	106.382
Madras	127,790	57,016,002	446.170
Bombay	111,434	35,956,150	322.668
Madhya Pradesh	130,272	21,247,533	163.101
Punjab	37,378	12,641,205	338.199

From the above table several important conclusions follow which must profoundly affect the financial system and budgetary policy of the Government. In India where the average density of population in extensive rural areas exceeds that of almost any other part of the world extreme poverty must prevail. The assertion that India is not overpopulated, in face of a smaller produce per head, cannot be supported. Under present conditions "there is good reason to suppose that in many areas the 'optimum'

[1] The total area of Pakistan is 3,61,000 square miles which accounts for less than one-fifth area of undivided India. The estimated population of Pakistan (1950) is 80,181,000.

[2] 1941 census figures.

population has long since been surpassed." The excessive pressure of the population must result in a miserably low standard of life of the masses. This must inevitably react on the finances of the Government and make its task more difficult.

Secondly, the unequal distribution of population (combined with physical facts and natural resources) accounts for the conclusion 'that the standard of service rendered by Provincial Governments—both in quality and in amount—is appreciably lower in the poorer parts of India than in those that are more well-to-do.'[1] The above assertion of the Indian Statutory Commission (1930) is still supported by the disparities between the total expenditure per head in various States. This is shown in the following table :

(In Rupees)

Name of State	Estimated per capita revenue based on budget of 1950-51	Per capita expenditure on security services	Per capita expenditure on social services
Bombay ...	18.77	5.64	6.69
West Bengal ...	13.95	3.17	3.50
Uttar Pradesh ...	8.48	3.85	4.40
Assam ...	10.61	2.78	2.76
Madras ...	10.17	2.21	2.55
Orissa ...	7.40	2.08	3.32
Hyderabad ...	14.48	3.82	4.79
Rajasthan ...	10.95	3.04	3.13
Bihar ...	6.57	1.80	2.04

Thirdly, the unequal distribution of population creates difficulties in the allocation of resources. Indeed the vast differences in areas and population make it very difficult to set up any standard for the allocation of resources which may be acceptable to all the States. The authors of the Indian Statutory Commission rightly observed that 'it costs more to run a province with a scattered population than one which is densely populated; the cost of roads and medical and sanitary services must be higher per head.'[2] Hence in any attempt to establish an objective standard of fairness between the States in the distribution of

[1] See *Report of the Indian Statutory Commission, Cmd.* 3569 (1930), p. 232.
[2] Cmd. 3569 (1930), p. 232.

resources the factors of population and areas should be taken into consideration.

Agriculture and Budgetary Policy

The predominantly rural character of the population and the dependence of the vast majority of the people upon agriculture has profoundly affected the budgetary calculations and the nature of Indian financial problems. In recent years the food position has continued to cause grave anxiety both to the State Governments and the Central Government. The most important reason for the unfavourable balance of payments position is our imports of foodgrains. In 1944-45 and 1945-46 the value of foodgrains imported was Rs. 14 crores and Rs. 24 crores respectively. In 1946-47 the figure was Rs. 89 crores. During 1947-48 food worth Rs. 130 crores was imported. The Government of India had also to spend huge amounts of money to subsidise the prices of imported foodgrains.

The influence of agriculture on the budgetary policy of Central and State Governments has been very much increased on account of the partition of the country. The important wheat and jute growing areas have gone to Pakistan. Besides, Pakistan's agriculture is in a more prosperous condition on account of better irrigation facilities and the production of commercial crops. An analysis of the net area sown in the various States of India is given in the following table :—[1]

States	Net areas sown during 1945-46	Net area sown per head of population (In Acres)
India	170,808	0.7
Assam	5,378	0.7
Bihar	17,506	0.5
Bombay	27,557	1.1
Madhya Pradesh (C.P. & Berar)	24,302	1.2
East Punjab	11,617	1.0
Madras	30,534	0.6
Orissa	6,453	4.8
Uttar Pradesh	37,410	0.7

[1] Note : 1. Net area sown is in thousands of acres.
2. Area sown per head is based on the census of 1941.

The obvious conclusion which can be drawn from the above table is that the pressure of population on the land is very heavy in India. The future budgetary policy of the country is thus most closely bound up with the prosperity of agriculture. Unless agriculture is placed on a sounder and healthier basis the *per capita* income of the masses cannot be substantially increased.

The Monsoon and the Budget

A former Finance Member of the Government of India called the Indian estimates a 'gamble in rain'. Although modern financial conditions have very much reduced the importance of land revenue as the most important source of revenue of the Government, still the monsoon continues to be the most disturbing factor in the budget of the State Governments. An unfavourable monsoon means expenditure on famine relief and suspensions and remissions of land revenue by the State Government. The finances of the Central Government are also affected indirectly. Failure of rainfall reduces the purchasing power of the masses which tends to diminish the volume of the external and internal trade of the country. This reduces the receipts from customs, income-tax and railways which are the principal sources of revenue of the Central Government.

During the nineteenth century much energy and money were spent in the handling of the problem of drought and in the organisation of famine relief. During recent times the worst effects of the failure of the monsoon rainfall have been guarded against with the construction of huge irrigation works and the improvement of means of communication and transportation, especially the construction of railways. Nevertheless, even today as more than four-fifths of the cultivated area is still dependent upon the rainfall, the monsoon months are a subject of deep concern to the masses in general and to the cultivator and the Government in particular.

With the partition of the country, India's position regarding irrigation has undergone a remarkable change. The following

table gives the irrigated area in undivided India, India and Pakistan :—

(In thousands of Acres)

	Irrigated Area	Net area Sown	Percentage of irrigated area to net area sown.
Undivided India	70,700	286,216	24.5
India	48,228	236,808	20.2
Pakistan	22,482	49,418	45.0

From the above table it would appear that the percentage of irrigated area to area net sown has declined from 24.5 per cent. to 20.2 per cent. in case of India. One of the major problems before the Government of India and the States is to provide additional funds for irrigation facilities so that the grow-more-food schemes may succeed.

Perhaps no sphere of Governmental activity during the last half century has benefited the cultivators more than irrigation; it helps the farmer to avoid debt; it enables him to keep himself busy all the year round; it has increased national prosperity and ensured the State's revenues. There can be no doubt that the influence of irrigation is deeply rooted in the system of State finances. Its importance, however, varies in different States.

Conclusions

We have now reviewed very briefly the chief characteristics of India, noting in particular the effects of the size, the population, and the occupations on the system of public finance in India. From this brief summary some broad conclusions can be drawn. In the first place, on account of the dominating position occupied by agriculture in the life of the people, the financial problems of the Indian Government are somewhat different from those of western countries. This must change the direction of public expenditure. *Secondly,* the population problem undoubtedly is one of the most serious obstacles to increasing the quality of the social services supplied by the Government. There are some economists who hold that India can support an even larger population if the best means of production, distribution and consumption are adopted. Be this as it may, the possibilities of future industrialization are of small consolation to the present Government.

Thirdly, much of the activity of the Government which helps the cultivator in his difficulties adds enormously to the happiness of the country as a whole. More than thirty years ago the authors of the Montagu-Chelmsford Reforms drew the following picture of the needs of the cultivator :

'The ryot and hundreds of thousands of his kind may be lifted from penury to comfort by a canal project costing millions of pounds. One of his constant needs is protection against the exaction of petty official oppressors. Improvements in seed or stock, manures, ploughs, wells ; the building of a new road or a new railway ; facilities for grazing his cattle or getting wood for his implements ; the protection of his crop from wild animals ; his cattle from disease and his brass vessels from burglars ; co-operative banks to lend him money and co-operative societies to develop his market ; the provision of schools and dispensaries within reasonable distance—these are the things that make all the difference to his life.[1]

The three decades that have passed since the above passage was written have witnessed great growth. Schools have increased; agrarian legislation has been passed ; the introduction of agricultural research and experimentation have placed improved methods of cultivation at the disposal of the cultivator ; and the number of co-operative societies has increased. Still so far only the fringe of the problems has been touched. Hence it is an imperative duty of the Government to assist and to protect the interests of the Indian ryot through a judicious system of public finance. 'The rural classes have the greatest stake in the country because they contribute most to its revenues.'[2]

§2. *PRINCIPLES OF FEDERAL FINANCE*

Having described some of the features of the Indian economy which affect State finances after the partition of the country we pass on to discuss some of the fundamental principles of Federal Finance which should be kept in view in the allocation of resources between the Union and the States.

[1] Report on *Indian Constitutional Reforms,* Cmd. 9109 (1918), p. 114.
[2] See Cmd. 9109 (1918), pp. 114-15.

Allocation of Functions

The problem of the division of taxing powers and functions between a federation and the states or federating authorities, is necessarily one of difficulty. The problem would be simplified if it were possible to allocate separate sources of revenue to the two authorities which would fit in with the economic and financial requirements of each party. But this has not been found possible in actual experience in the financial systems of leading federations. For, as Sir Cecil Kisch has observed, it would be more or less of an accident if the revenue appropriate to federal and state exploitation yielded precisely the sums needed for the discharge of federal and state functions. Nature is not so accommodating. Hence there arises a need for compromises entailing concurrent jurisdiction in the realm of both taxation and administration.

Since the test of the adequacy of taxing powers of the Federation or the States depends upon the functions performed by each, let us start the study by stating the principles upon which the division of functions takes place. Economy, administrative convenience and efficiency have been the leading principles in the distribution of functions. These principles have guided the rival claims of centralization and decentralization. It will appear at once that certain functions can best be performed by the Federation, while others are more suitable for the federating states or local authorities. Thus functions of an international character, like defence, foreign relations, foreign trade or commerce; or functions which are predominantly national in character, such as railways, currency and coinage, regulation of inter-state commerce and communication and so on, are definitely federal and should be administered by the Central Government. Similarly, functions such as education, law and order, police, agriculture, health, medical, are fit for the administration of the federating states or local authorities. It may, however, be mentioned that in some cases it may be desirable, to secure uniform progress, to have State administration and Federal legislation. We may also have concurrent administration (e.g., conditions of labour).

The actual distribution of functions in a federation is dependent upon a number of considerations. In some federations there

may be extreme centralization; in others extreme decentralization. In the main, in most cases, the tendency has been along the lines indicated above. It is not possible to restrict rigidly the scope of Federal and State functions since no Chinese wall exists between them. In practice, there must be some overlapping. But the broad principles of economy, administrative convenience and efficiency should always be a guide whenever any difficulty, in the concurrent zone of administration, arises.

Distribution of Resources

The rationale of the distribution of resources follows closely the principles adopted in the distribution of functions. Professor Seligman mentions three such principles: *viz.* the principles of efficiency, suitability and adequacy. Efficiency and suitability depend upon the nature of the tax and its administration. 'No matter how well intentioned a scheme may be, or how completely it may harmonize with the abstract principles of justice, if the system does not work administratively, it is doomed to failure.'[1] The problems of efficiency and suitability really depend upon the choice between a wide or a narrow tax basis. Where efficiency demands national uniformity combined with effective administrative supervision, the tax basis must be wide. Similarly, where the tax varies with localities and its assessment requires the most exact knowledge of local conditions, a locally administered tax will be more efficient. Other taxes less local in character or less well fitted for national assessment, because of administrative difficulties, are obviously suitable for states.

The principles of efficiency and suitability have led to the division of the sources of revenue in a country into three classes: (i) Sources of revenue assigned to the Federation; (ii) sources of revenue assigned to the States; and (iii) concurrent sources of revenue in which both the Federation and the States can tax within certain well-defined restrictions. Even this triple division of resources sometimes results in deficits either in the Federation or the States; in such a case the deficit is made up either by federal subsidies or contributions from the States. To this we come in

[1] Seligman, F. R. A., *Essays in Taxation* (Macmillan) 1952, 10th edition, p. 378.

the next section. Hence we shall briefly state the general scheme of distribution adopted in most federations.

In most federations we find that the exclusive federal taxes consist of indirect taxes such as customs and excise taxes ; receipts from federal property ; earnings from commercial monopolies like those of salt and tobacco ; and receipts from commercial undertakings. In the last case the common practice is to have separate budgets for railways, posts and telegraphs. The States generally have powers of direct taxation, such as taxation of incomes, property and inheritances, and state property. The concurrent tax zone is often composed of income-tax, corporation tax, death duties and excises. The practice, however, differs from federation to federation.[1]

The Principle of Adequacy

This brings us to the principle of adequacy. The principles of efficiency and suitability are primarily concerned with administrative efficiency. The principle of adequacy has three important aspects : (i) The apportionment of revenues between the Federation and the States, (ii) the allocation of revenues (in a federation or a state) between different services, and (iii) the question of 'collection', *i.e.,* some taxes may be collected by the federal authority, but shared between the federal authority and the States.

Together with the division of functions between the Federation and the States a simultaneous division of resources becomes essential. The allocation of resources should ultimately rest upon the functions performed by each government. Here difficulties arise, *First,* the division of the sources of revenue, suggested above, though it satisfies the conditions of efficiency and suitability, often fails to fulfil the condition of adequacy. For the functions of the States are usually expanding and require larger resources and the sources of revenue assigned to them are often inadequate for their requirements. *Secondly,* the yield from the same source of revenue varies greatly in different States. *Thirdly,* the needs of each state, on account of differences in economic and natural conditions and

[1] For an account of the financial practice in some federations see Adarkar, B.P., *Principles and Problems of Federal Finance* (P. S. King), 1933.

population are different.[1] Hence the allocation of the same heads of revenue to each state breaks down on the principles of adequacy. Therefore, there should be some heads of revenue which should be 'balancing factors' to correct inter-state inequalities.

The Principle of Transferences

The ideal allocation of resources between the Federation and the States should be in accordance with the principle of the 'national minimum' for people living in different states.[2] This can be achieved through transferences from rich areas to poor areas in a federal state. The basic reason for these transferences is to reduce inter-state inequality of incomes. It must be remembered that vast inequalities in the distribution of income between people living in various states is not conducive to the prosperity of a nation. The machinery of public finance, through a judicious policy of transferences, can be employed to correct such inequalities of incomes.

It is unfortunate that whenever an attempt is made to transfer resources from one area to another fierce wrangling takes place between the States. People think in terms of states or artificial provincial boundaries rather than in terms of people. The financial history of the States in India shows that bitter jealousy was caused at the revision of each financial settlement.[3] The ideal of a well-operated system of federal finance should be to provide the national minimum to the people whether they live in one State or another.

The application of transferences cannot be easily achieved. It may be assumed that each State attempts to transfer its resources, within its borders, from the rich to the poor. The Federal Government should step in to fill in the gaps of unevenness between States caused by differences in natural conditions or population. Thus poor areas, on account of deficiency of natural resources, heavy population or lack of capital resources, need special treatment. Apart from social considerations, the economic reasons for a federal government to discriminate

[1] See chs. iii and iv.
[2] See Appendix 1.
[3] See chs. ii, iii and iv.

between the various States are legitimate and clear. The burden of indirect taxes is always heavier on the poorer classes. For example, in India, the State of Bihar, on account of the heavy pressure of population, contributes more in customs and excise than the other comparatively richer, but sparsely populated, States. Special subsidies and subventions should be granted in such cases for developmental expenditure or for other objects to achieve the national minimum. In order that the subsidies or subventions may be properly utilized the Federal Government should exercise some supervision over the financial conditions of the recipient states.[1]

Allocation between Different Services

The other aspect of the principle of adequacy namely, the allocation between different services, is extremely important. There must be allocation of resources between the different services, whether they are performed by the Federal or State Governments. The services performed by the State may be divided into two broad classes : (i) general public services and (ii) special public services.[2] The latter may again be divided into three classes : (a) services which can be provided by private enterprise but which the State provides to better advantage on account of administrative convenience and efficiency, e.g., free roads paid for by taxation ; (b) services (e.g., poor relief, education, etc.) for which most taxpayers agree to contribute (as suggested elsewhere), on account of what may be called the 'social conscience'; and (c) services in the nature of public utility, e.g. railways, gas, electricity, etc.[3] Here the State restricts the powers of monopolies and often charges discriminating prices.

Let us begin by asking upon what considerations the State should distribute its revenues between these services? How much should it allocate for general public services, social services and public utilities? Clearly, in the first two cases the costs principle cannot operate ; in the last, the concept of costs is of fundamental importance. We begin our analysis by saying that all economic

1 The relation of Local Finance to State Finance is discussed in § 3 of this chap. and in chap. x.
2 See Appendix 1.
3 See Benham, F., *Economics* (Pitman), 1938, pp. 288-99.

activity depends upon the type of state. In dictatorships a disproportionate influence on the policy of the Government by a small minority of persons may lead to a diversion of economic resources into different channels from that in democratic countries. Nevertheless, in most countries the state tries to diminish inequality of incomes by spending on social services, such as education, public health, medical and poor relief.

In our daily economic life millions of private decisions and business decisions are made by individuals or businessmen between the different courses of action open to them. One individual prefers one decision as compared with another. A man may decide to pass a week-end outside London instead of buying a suit. An entrepreneur controlling the policy of a firm may decide to increase its output and charge discriminating prices from the consumers. Such decisions are mostly determined as a result of a deliberate choice made after carefully considering, and rejecting possible alternative courses.[1] They ultimately depend upon what economists call the concept of 'opportunity cost'.

In the distribution of public expenditure between various services, with a limited quantity of available resources, the statesman has to eliminate some expenditures and approve others. His choice is affected by two considerations: first, the inherent utility of the expenditure, on the basis of which it is placed on a list of *possible* expenditures; and second, from the standpoint of the utility of the expenditure under consideration as compared with the utility of other expenditures that are equally possible, on the basis of which it comes to be a *preferred* expenditure.[2]

The rationale of public expenditure, as stated above, is often difficult to put into practice. The statesman must make a vast multitude of decisions. He must decide how to distribute the available resources among the various services. He must decide how much to spend on the army, navy, education, public health, and hundreds of other services. A large part of the expenditure is fixed (e.g. the King's Civil List) or is the result of past actions (e.g. interest on war debts). Some expenditure is decided on the

[1] Benham; op. cit. p. 7.

[2] A. De Viti de Marco, *First Principles of Public Finance* (Cape) 1936, Introduction by Professor Luidi Einaudi, p. 24.

spur of the moment (e.g. war emergency expenditure), other is due to vested interests or in order to 'safeguard' the interests of 'minorities'. Nevertheless, most expenditure is the result of deliberate decisions.

The ultimate allocation is an extremely difficult task on which widely different opinions are held by different people. It may be claimed that one scheme is better than another. My own opinion, expressed with all due diffidence, is that a reasoned criticism requires a considerable study of economics and political science. Unfortunately, criticism in India is often based more on sentiment and prejudice than on informed judgments.

Allocation a Matter of Compromise

To evolve a system of financial allocation in India, in conformity with the principles of efficiency, suitability and adequacy, is an extremely difficult task. Constitutional, natural and economic considerations place insurmountable difficulties in its way. A system which would obviously secure efficiency and suitability would break down on the principle of adequacy. Moreover, a system that might suggest itself as the most acceptable would not satisfy the conflicting claims and counter-claims of the various States. Hence financial allocation between the Government of India and the States has always been a matter of compromise. Such 'compromises' are reflected in the system of 'doles' from the Centre to the States or 'contributions' from the States to the Centre or in the system of 'shared revenues'. In chapters ii and iii we study the history of State finance. Here we shall endeavour to ascertain some underlying principles which must be borne in mind in making a permanent choice in the allocation of revenue resources between the States and the Centre. We do this by examining some of the main sources of revenue in India.

Allocation of the Principal Sources of Revenue

Land revenue is one of the most important sources of revenue in India. It must be administered by the State Governments, for the system of land tenures, basis of assessment and types of settlement vary in different States. The State Governments possess the most exact knowledge of local conditions upon which land

revenue depends. As agricultural productivity depends upon adequate water supplies the yield from land revenue is closely bound up with irrigation. Hence irrigation finance is also a suitable subject for State administration. In fact, irrigation rates are collected along with land revenue. Excise duties on country spirit and intoxicants, on account of administrative convenience, are well fitted for State administration. The two other heads of revenue where effectiveness of State administration would increase revenue are forests and stamps. Hence forest developmental policy needs State interest and supervision. Stamps are divided into two well-marked sub-heads, general and judicial; the former, to preserve uniformity of rates (in the case of commercial stamps), need Central legislation but State administration. Judicial stamps, to increase effectiveness of administration, need State control. Both, however, should be State heads of revenue. This arrangement would secure uniformity of rates, effectiveness of administration and adequacy of resources to the States; the States having a free hand in adjusting court fee rates. Central administration in any of these heads of revenue would decrease efficiency of administration and yield.

Just as State administration of revenues in some cases is superior to Central administration, it may be expected that in some cases Central administration will be superior to State. Customs, salt, railways, posts and telegraphs, opium or excises, by the very character of the tax or service, would undoubtedly be far more efficiently administered by the Central rather than State Governments. The extreme difficulty of allocating the yield among the States, the need for uniformity and Central control and the use of the broadest tax jurisdiction, make them suitable for the Federation.

Some doubts may arise regarding income-tax. Whether the proceeds are apportioned in whole or in part to the States, the collection, assessment and administration, to secure uniformity and efficiency, should be by the Federation. The same reasons equally apply to super-tax, corporation tax and death duties. In modern India, through the working of economic forces, the income of the taxpayers has very little to do with the State in which they happen to live. Thus receipts from the taxation of

corporations (whose holdings are spread over the country) cannot be allocated to any State. Hence to avoid the conflicts of tax-jurisdiction, inter-state jealousies and complications (e.g. the movement of labour and capital), these taxes should be collected centrally though the proceeds might be shared. The State Government, however, may be given the right to levy surcharges within a fixed percentage. As the tax revenue would be spent within the State the dangers of excessive taxation should not be exaggerated.

Balancing Factors

The above allocation of resources, on theoretical grounds, appears to be sound. But on the principle of adequacy it fails. *First,* because the yield from land revenue is different in different States. *Secondly,* the functions of the State Governments are expanding and their sources of revenue are almost inelastic. *Thirdly,* the needs of each State on account of natural, economic, and population considerations are different. Hence, the above allocation is either inadequate to the needs or creates inter-state inequalities. Therefore, there must be some heads of revenue which should be 'balancing factors' to correct inter-state inequalities and to introduce an element of greater elasticity in State revenues. In short, certain resources should be transferred from the Federation to the States. The most important heads of revenue which can be admirable balancing factors are income-tax, excises on such commodities as matches, cloth, sugar and tobacco and the export duties, such as that at present levied on jute.

The allocation of the proceeds of taxation from the balancing factors depends upon varying considerations—political, economic, natural or social. The justice (or injustice) of the allocation would depend upon the weight attached to each consideration by the financier. This would vary with his discretion. However, the most important principle which should be the ideal of the financier is to transfer resources from the richer to the poorer States in order to attain the national minimum. In translating this ideal into practice he must be guided, in India, amongst other factors, by (i) the state of its finances; (ii) natural resources;

(iii) climate and rainfall; (iv) population; and (v) the state of its economic development. The distribution of the resources by the Federation based upon these factors would fill in the gaps and inequalities resulting from artificial state boundaries or other considerations.

§3. *LOCAL FINANCE*

Need for Co-ordination

Finally, there must be co-ordination in financial administration, resources and expenditure between local authorities and State Governments. In a later chapter we shall see that with independent taxes, inadequate resources and growing local functions, local finance is inefficient and uneconomical. Efficiency and economy in local finance can be introduced by (i) developing the resources of local authorities and (ii) co-ordinating the resources of local authorities and State Governments through a system of grants-in-aid. The theory of grants-in-aid will be found in chapter X. There we try to show the main problems of local authorities, and by what methods they are to be solved. For the present, we are analysing the principles of local finance.

Onerous and Beneficial Services

In a discussion on the principles of local finance it is desirable to distinguish between national or onerous and local or beneficial, services—a distinction to which adequate attention has not been paid in the field of local finance in India. This distinction, however, is highly important in the theory of grants-in-aid.

The Royal Commission on Local Taxation in England (1901) observed that services which are preponderantly national in character and generally onerous to the rate-payers are 'onerous' and services which are preponderantly local in character and confer upon rate-payers a direct and peculiar benefit more or less commensurate with the burden are 'beneficial'. The Commission further observed that the distinction cannot, it is true, be drawn with absolute and logical precision. In many cases it is plain enough, e.g. just as water-rates are held to be payments for service rendered rather than taxes, so also it is clear that drainage works are a local benefit of a similar kind. But in other

cases, the two elements are combined in different degrees, since almost all useful local expenditure is indirectly advantageous to the country at large.[1]

Professor Cannan distinguishes between onerous and beneficial services on the ground of the benefit which local expenditure confers upon rate-payers. An 'onerous' local service is one which is regarded as a burden because it is not worth to the local taxpayers what it costs them.[2] At another place he further explains the idea : 'Expenditure out of rates receives the name of 'beneficial' if its direct effect is sufficient to more than counterbalance the opposite effect of the addition to rates, so that in spite of the addition to rates, it tends to cause an actual rise in the value of immoveable property, while expenditure out of rates which depresses the value of property, is called 'onerous'.[3]

Principles of Local Finance

The classification of the local services into onerous and beneficial raises two important problems which have a bearing on the financial relations between the State Governments and local authorities.

These problems are :

(i) The equity of local rates ; and

(ii) The financing of local services.

Each of these problems needs close attention.

Local finance differs in one fundamental respect from national finance. Though the object of a government in levying a tax is to render services directly or indirectly to the taxpayer, yet, in the case of an individual it is impossible to establish a correlation between the amount of the tax paid and the amount of the benefit received. The essence of a tax, says Professor Taussig, 'as dis-

1 *Royal Commission on Local Taxation,* Cmd. 638 (1901) p. 12. As a result of the above distinction the Commission came to the conclusion that Poor Relief is a national service; Police and Criminal Prosecution are also predominantly national; and Education is also a national service in a high degree. The maintenance of Main Roads on the whole is a national service and will become more and more so with the increasing mobility of population and development of means of transportation and communication.

2 Cannan, E. *History of Local Rates in England* (P. S. King), 2nd Edition, 1912, p. 168.

3 Cannan, op. cit., p. 168.

tinguished from other charges, is the absence of a direct *quid pro quo* between the taxpayer and the public authority'. In local taxation, however, in some cases, it is possible to measure the benefit received and to correlate this with the amount of the tax paid. Some local taxes are specially levied to benefit the inhabitants of particular localities.

While discussing the benefit and ability theories of taxation we observed that while the ability theory has a greater application in national finance, the benefit principle comes into play in local taxation. It should not, however, be inferred from the above statement that the principle of ability has no place in local finance. The principles of local finance correctly enunciated must contain both elements. The difference between the principles of national finance and local finance comes to this: whereas in national finance a great weight should be given to the ability principle, in local finance a greater weight should be given to the benefit principle. Both the principles in a judicious system of taxation, must supplement each other.[1]

The principles of local finance have been put by Professor Cannan thus:

(i) That every inhabitant of a district should be made to contribute according to his ability; and

(ii) That everyone who receives benefit from local expenditure should be made to contribute in proportion to the benefit he receives.[2]

These two principles, applied to the same rate, are obviously incompatible; ordinarily the benefit conferred by any kind of Government expenditure is hardly in proportion to the ability of a taxpayer. But in local taxation it happens in practice that taxes on property benefit the persons in proportion to their ability to contribute. Everyone agrees that the supply of important beneficial services, e.g. water supply, drainage, town improvement, lighting, regulation of traffic, construction and maintenance of local highways, paths and bridges, should be paid for by each individual in proportion to the benefit secured by him. In practice, however, an actual measurement of the quantity of com-

[1] See Appendix I.
[2] Cannan, op. cit., p. 159.

modity or service taken is either impossible or difficult and expensive. To measure the quantity of roads consumed by a particular person or the street lighting required by a person is impossible. Hence a tax on annual value is often levied by municipalities for financing some of the beneficial services. This assumes that the benefit received by a taxpayer is proportional to the value of property owned by him. Similarly it is thought that the value of property owned reflects his ability to pay the tax.

In some cases, for separate services, where accurate measurement is possible, separate charges are made. The proportional cost of service principles is illustrated where municipalities charge for water on the quantity of water consumed, *viz.* by fixing meters. But where the water-rate is fixed in proportion to the rental value of property, the charge is progressive, as houses of small rental value evidently use proportionately more water than those of high.

On what principle should a local authority it may be asked fix its charges for beneficial services which are in the nature of public utilities? The costs of such services may be divided into two parts : (i) marginal costs and (ii) fixed costs. Theoretical considerations enable us to say that each consumer should pay the marginal cost of the service incurred by the local authority. In allocating fixed costs some difficulty arises. It is sometimes held that fixed costs should be met out of general revenue. This method is, I think, unsound ; for there is no reason why those who do not consume the service should pay a subsidy for the supply of the service. It is fair, I think, that the users of services should pay the fixed costs in proportion to their use. The adoption of this principle would mean that every consumer should pay the marginal costs while those who consume a larger quantity of the service should pay more towards fixed costs than those who consume less. No doubt, in some circumstances (for example the supply of water in a tropical country) social considerations may demand that relatively rich people should pay for relatively poor people ; but theoretically in the case of public utility services the best course is not to raise funds for the subsidy to be distributed among the poor in proportion to their consumption of a particular commodity.

The adoption of the above principle would not cause administrative inconvenience; for example, in the case of electricity the fixed costs may be allocated on the number of points a person may have in his house.[1]

Onerous services benefit not only the locality but the nation as a whole : for instance education. Local children receive the education but the nation is benefited. Under the present conditions of local finance in India either the residents of poor areas are not provided with the necessary minimum of onerous services or they are required to pay disproportionately higher taxes than they should be required to pay. The system creates inequalities of local taxation between individuals and between districts.

To make local taxation more equitable as between individuals and districts expenditure on onerous services should be borne jointly by State Governments and local authorities. The result of this change would be that in applying the principle of ability in local finance, we should take into consideration the actual circumstances, of each locality and transfer any part of the local burden to State funds which the locality is unable to bear. The transfer of local burdens to State funds would bring about a fairer distribution of tax burdens between both individuals and districts.[2]

[1] Incidentally, it may be mentioned here that the State should help the poor in other ways, e.g. free provision of elementary education, rather than by distributing the fixed costs on the general body of taxpayers.
[2] See ch. x for further discussion.

II

HISTORY OF PROVINCIAL FINANCE

(1833–1919)

A knowledge of the history of the financial settlements between the Central and Provincial Governments is necessary in order to appreciate the nature and extent of the changes brought about by the reforms of 1919. The historical background has an important bearing on present and future financial arrangements and cannot be altogether ignored. No doubt it is impossible to correct past mistakes, and it is useless to revive old controversies—yet a knowledge of the past ensures foresight and care in shaping the future policy of the country. I shall, therefore, briefly trace the history of the financial settlements prior to 1919 in order to understand the changes brought about by the Reforms.

§ 1. *CENTRALISED SYSTEM OF FINANCE (1833–71)*

The Charter Act of 1833

In the field of provincial finance, prior to 1871 both revenue and expenditure were rigorously centralized in the Central Government. The centralized system of finance was the necessary result of the centralized system of administration. During this period (1833–71) no Provincial Government could keep any part of its collections and it could not undertake any expenditure without the previous sanction of the Government of India.

The Charter Act of 1833 is a landmark in the history of Indian administration and finance. It introduced a system of centralized administration and vested the superintendence, direction and control of the whole civil and military government and revenues in the Governor-General of India in Council.

In regard to finance it was laid down that, without the previous sanction of the Governor-General in Council, the Provinces were not to spend the revenues allowed to them in creating any new office, or granting any salary, gratuity or allowance.[1] This rigorous control of the Central Government in provincial financial matters is described by the Strachey brothers in the following words :

> The Local Governments (*i.e. Provincial*), which practically carried on the whole administration of the country, were left with almost no powers of financial control over the affairs of their respective provinces, and no financial responsibility. Everything was rigorously centralized in the Supreme Government, which took upon itself the entire distribution of the funds needed for the public service throughout India. It controlled the smallest details of every branch of the expenditure; its authority was required for the employment of every person paid with public money, however small his salary; and its sanction was necessary for the grant of funds even for purely local works of improvement, for every local road, and every building, however insignificant.[2]

Political and military exigencies made it difficult to draw exact lines between the functions of the Imperial and Provincial Governments. In fact the whole tendency was towards the centralization of administration. The increasing ease and rapidity of the means of communication, the spread of the use of the

[1] So rigorous was the control that the court of directors strongly condemned the action of Mr. A. Ross, the acting Governor of the North-Western Provinces, who, in anticipation of the sanction of the higher authorities, had abolished three custom houses in the interior of the Province. The dispatch concluded in these strong words: 'Such is the sense of the extreme want of judgment manifested by Mr. Ross on this occasion that, supposing he still continued to exercise the functions of government in the Presidency of Agra, we should have come to the conclusion of cancelling his appointment. In exercise of those powers we deem it necessary to direct that the administration of the Government of Agra be never again, under any circumstance, delegated to Mr. Ross.' *See Dispatch of the Court of Directors to the Government of India, 1st February, 1837, quoted in* Banerjee, *Provincial Finance in India,* p. 16.

[2] Strachey, Sir John and Lt.-Gen. Richard, *Finances and Public Works of India (from 1869 to 1881)* (Kegan, Paul, Trench & Co.) 1882. p. 134.

English language, the material development of the country and the increasing interest taken by Parliament in the details of Indian administration were some of the circumstances which favoured centralization.[1]

Defects of the System

The highly centralized system of finance was open to a number of gross abuses. The Provincial Governments administered the country but had no financial responsibility. This divorce of financial responsibility from administration resulted in extravagance. Economy comes with responsibility. When the responsibility for finding revenues rested with the Government of India, the provinces, as was natural, asked for as much as they could. The provinces thought that 'they had a purse to draw upon of unlimited, because unknown, depth; they saw, on every side, the necessity for improvements; their constant and justifiable desire was to obtain for their own provinces and people as large a share as they could persuade the Government of India to give them out of the general revenues of the empire; they found by experience that the less economy they practised, and the more importunate their demands, the more likely they were to persuade the Government of India of the urgency of their requirements. In representing and pressing those requirements, they felt that they did what was right, and they left to the Government of India, which had taken the task upon itself, the responsibility of refusing to provide the necessary means.'[2]

Thus the distribution of the funds was based not upon any fixed principle, nor on the resources, needs or expenditure of the provinces, but according to the relative claims and clamour of each Provincial Government on the purse of the Government of India. The result, in the words of General Richard Strachey, was that 'the distribution of the public income degenerates into something like a scramble, in which the most violent has the advantage, with very little attention to reason'.[3]

[1] See *Report of the Royal Commission upon Decentralization in India*, Cmd. 4360 (1908), par. 47.

[2] Strachey, op. cit., pp. 136-7.

[3] Ibid., p. 137.

Moreover, the Government of India in the absence of an efficient machinery of audit and the vast area of the country could not exercise an effective control over provincial expenditure. A careful system of audit and accounts had hardly developed. The budget grants were never carefully prepared or checked. In brief, as Dr Ambedkar puts it, so long as the Government of India remained without an appropriation budget and a centralized system of audit and account, it continued to be only a titular authority in the matter of financial control, and the Provinces, though by law the weakest of authorities in financial matters, were really the masters of the situation.[1] Thus the centralized system of finance developed financial irresponsibility and put a premium on inefficiency and extravagance.

Indian Councils Act (1861)

In 1858, as a result of the Mutiny the administration of India passed from the East India Company to the Crown. The final control of the finances now vested in the Secretary of State for India. So far as the internal control was concerned the India Councils Act (1861) did not modify the control of the Central Government over provincial financial matters. Centralization was still the most conspicuous feature of Indian administration.

A Period of Deficits

The financial needs of the country, however, on account of the huge deficits and debts left by the Company and the fast-growing public needs, required large sums to maintain financial equilibrium. The situation became extremely acute. In spite of the drastic economy in expenditure and the improvements in the machinery of financial administration, Mr. James Wilson, the Finance Member, could not restore financial equilibrium. Mr. Wilson in summing up the financial position in his financial statement for 1860-1 said : 'We have a

1 Ambedkar, B. R., *The Evolution of Provincial Finance in British India* (P. S. King) 1925, p. 27.

deficit in the last three years of £30,547,488 : we have a prospective deficit in the next year of £6,500,000; we have already to our debt £38,410,755.'[1] It is these Imperial deficits which suggested a policy of financial decentralization.[2]

§2. *FINANCIAL LANDMARKS IN THE LATER NINETEENTH AND EARLY TWENTIETH CENTURIES*

Lord Mayo's Reforms (1870)

From 1861 to 1870 eminent public administrations held divergent views regarding the transfer of the control of financial responsibilities from the Imperial to the Provincial Governments.[3] On December 14, 1870, Lord Mayo issued the famous Financial Resolution in which he proposed to enlarge the responsibility and control of the Provincial Governments in respect of the details of their own expenditure. Lord Mayo said : 'I believe, as I have repeatedly said, that if we place administration of portions, both of our revenue and expenditure, in the hands of the local Governments, it will lead to economy, to increased responsibility, to the avoidance of much administrative difficulty, and above all, it will enable the rulers of the country gradually to institute, in various parts of the Empire, something in the shape of local self-government, and will eventually tend to associate more and more the natives of this country in the conduct of public affairs.' Services like jails, police, education, roads and civil buildings, were transferred to the charge of the Provincial Governments. To meet the cost of these services (£4,514,332) on the

1 See *Financial Statement,* 1860-1. Speech of Mr. James Wilson, February 18, 1860, p. 6 (India Office Library).

2 During the period 1834-5 to 1857-8, there were seventeen years of deficit budgets and only seven years of surplus. The public debt of India during 1834 to 1857 increased from £41,350,952 to £59,441,052.

3 As early as 1861, Mr. Laing, the successor of Mr. James Wilson, advocated financial decentralization. Mr. Laing observed:

'It is most desirable to break through the system of barren uniformity and pedantic centralization which have tended in times past to reduce all India to dependence on the *bureaux* of Calcutta, and to give to local Governments the power and the responsibility of managing their own local affairs.' See *Financial Statement,* 1861-2. Speech of Mr. Samuel Laing. Finance Member, April 16, 1862, p. 89. (*Financial Statements,* 1860-1 to 1873. India Office Library.)

basis of the figures of 1869-70, Lord Mayo transferred the excise receipts of £2,000,000 and a lump sum assignment of £1,500,000; the remaining million pounds was to be raised by the Provincial Governments by extra local taxation.[1]

Advantages of the Scheme

Lord Mayo's scheme was the first step in financial decentralization of the country. The scheme, it was expected, would produce greater care and economy in public expenditure, import an element of certainty into the financial system and would ultimately result in creating harmonious feelings between the Central and Provincial Governments. 'Above all,' wrote Lord Mayo, 'local interest, supervision and care, are necessary to success in the management of funds devoted to education, sanitation, medical charity and local public works. The operation of this resolution in its full meaning and integrity will afford opportunities for the development of self-government, for strengthening municipal institutions, and for the association of natives and Europeans, to a greater extent than heretofore, in the administration of affairs.'

Lord Mayo's scheme of decentralization was prompted by two objects, namely relieving the Imperial Government from the financial chaos caused by constant deficits, by developing local sources of revenue, and secondly developing a sense of responsibility in Provincial Governments by the economical management of their finances.[2] The second object was based upon the elementary principle of public finance that tax administrations and appropriation must, as far as possible, go together. That both of these results were happily realized can hardly be challenged by any critic of the scheme. A study of the provincial budgets between 1871-2 to 1876-7 shows that surpluses outnumbered the deficits both in frequency and magnitude and even the deficits could easily have been met from the accumulated balances of the past. The Imperial Government directly gained an annual relief

[1] See Banerjee, P., *Provincial Finance in India* (Macmillan) 1929, p. 62.

[2] Between 1860 and 1870 the three Indian Finance Members could only show *three* surplus years, in spite of constant enhancement of taxation, rigid economy and retrenchment.

of £330,801; besides there was an improvement in the efficiency of the services transferred to the charge of the Provincial Governments.

Defects of the Scheme

Perhaps the greatest defect of Lord Mayo's scheme was that the settlement of 1871 was based on the actual expenditure of the Provinces for 1870-1. The expenditure of that year, on account of past inequalities, was very unequally distributed. The expenditure of Bombay, for example, on the services transferred was more than double that of Madras and the United Provinces, and nearly treble that of Bengal.[1] The Central Provinces and the Punjab were also far behind Bombay in the scale of their expenditure. Mr. Gokhale in his evidence before the Welby Commission, 1896, said: 'The fact is that these inequalities are a legacy from the pre-decentralization period, when the expenditure of different Provinces was determined...not by the resources or requirements of those Provinces, but by the attention that their Governments succeeded in securing from the Central Government, *i.e.* by the clamour that they made. And when the first step was taken in 1870 in the matter of decentralization, the level of expenditure that had been reached in the different Provinces was taken as the basis on which the contracts were made, and the inequalities that then existed were, so to say, stereotyped. I think it is high time that an effort should be made gradually to rectify these inequalities.'[2]

Thus were laid the foundations of inequalities in provincial finance—inequalities which were stereotyped with each step in the financial decentralization of the country. The successive financial settlements not only did not remove the inequalities of the past but accentuated these disparities, with the result that the task of the future financiers has become extremely difficult. The policy of doles and contributions to meet the exigencies of the times (besides for some other reasons), has made it impossible

1 See Gyan Chand, *The Essentials of Federal Finance* (Oxford University Press) 1930, pp. 36-37.

2 Evidence of Mr. G. K. Gokhale, *The Welby Commission Report,* Vol. III, p. 217. Q. 18094. Cmd. 130 (1900).

to do inter-provincial justice in the assignment of funds. Thus some of the most difficult present-day problems of financial adjustment of burdens and resources among the provinces owe their origin to the days of extreme centralization. The authors of the Reforms and the Federal Constitution had to face extreme difficulties in solving the financial problems relating to inter-provincial claims and counter-claims. This, however, is to anticipate the discussion.

Lord Lytton's Reforms (1877)

The next step in financial decentralization was taken by Lord Lytton in 1877. No doubt Lord Mayo's Government had effected a large reform, yet it suffered from the defect that the services which it left to the management of the Provinces were few. It also did not give the Provinces an effective inducement to develop the revenues collected in their territories. Moreover, the rigidity of the system of assignments was not favoured by the Provinces, because while the revenues collected in their territories were increasing the assignments allotted to them did not increase. It was also recognized that in order to encourage economy the interference of the Government of India in the details of provincial administration should decrease. That economy and good management go together was clearly realized by Sir John Strachey, who in his financial statement of 1877-8 stated that good management of finance was to be had 'not by any action which gentlemen of the financial department, or by any other department of the Supreme Government, can take whilst sitting hundreds or thousands of miles away in their offices in Calcutta or Simla; not by examining figures and writing circulars; but by giving to the Local Governments...a direct and, so to speak, a personal interest in efficient management.'[1]

Under the settlements the financial control of services like land revenue, excise, stamps, law and justice and general administration was transferred to the Provincial Governments; and at the same time the revenues raised from law and justice, excise, and the license (now income) tax was handed over to the Provinces. But as the departmental receipts from the services com-

[1] Strachey, op. cit., p. 143.

mitted to the provinces fell short of their requirements, the margin of deficit had to be met by an assignment. This was determined after taking into account the normal yield of the assigned revenues and their normal rate of growth. Further, any increase over the revenue, as it stood at the time of assignment, was shared between the Government of India and the Provinces—the former had also to bear a share of any decrease.[1] An important departure, however, was made with Burma and Assam (1879) which, instead on fixed assignments, were given a share of land revenue. Madras refused to accept the new system and continued to receive its revenue under the settlement of 1871.

Settlements of 1882

These settlements remained in force between the years 1877-8 to 1881-2. In 1882 fresh settlements were made with all the Provinces. The most important principle introduced by the settlement of 1882 was that, instead of giving to the Provincial Governments fixed grants of revenue they were granted the entire yield of some of the sources of revenue and a share in certain Imperial sources of revenue. Here we meet for the first time the classifications of revenue into 'Imperial', 'Provincial' and 'Divided'. The receipts from customs, salt, opium, post office and telegraphs, remained wholly Imperial. The income from forests, excise, license (income) tax, stamps and registration were divided equally between the Government of India and the Provinces; while the income classified under the head 'Provincial Rates' was made entirely provincial and 'local'. Besides the departmental receipts from law and justice, public works and education were also provincialized. The bulk of the income from railways and irrigation remained Imperial.[2] Along with this division of incomes there was also a division of expenditure, which, generally speaking, followed the incidence of the corresponding heads of receipts. But as the expenditure devolving on the Provincial Governments was larger than the revenues assigned to them, the difficulty of adjusting means to needs remained. Hence the excess of provincial expenditure was made up by assigning to each

1 See Cmd. 4360 (1908), p. 27

2 Ibid., p. 28.

Province a percentage of land revenue, which otherwise was an Imperial source of revenue.

By these settlements the Provincial Governments were given a direct interest not only in the provincial sources of revenue but also in the divided heads raised within their jurisdiction. The settlement also harmoniously united, to a considerable extent, the financial interests of the Central and Provincial Governments, which now not only shared the receipts but also the expenditure on certain heads. The system of divided heads remained the most important feature of provincial finance till it was abolished by the Reforms of 1919.

Defects of Quinquennial Settlements

The settlements of 1882 were quinquennial, and accordingly the provincial settlements were revised in 1887, 1892 and 1897. At these revisions no change of principle was introduced; except that as the shares of divided heads were not sufficient for the growing needs of the Provinces, they received, in addition, a special fixed assignment adjusted under the land-revenue head.[1]

The main object of the quinquennial settlements (as compared with the annual) was to introduce an element of greater financial stability for the Provinces; but in actual practice the provincial settlements caused much irritation and friction between the Central and Provincial Governments. The most important cause of bitter feelings between the two authorities was the resumption of the provincial surpluses by the Government of India at the close of each quinquennial settlement. The periodical revisions encouraged extravagance rather than economy, and introduced an element of uncertainty in place of stability. A trenchant criticism of the settlements was given by Sir A. Mackenzie, the Lieutenant-Governor of Bengal, in his speech in the Imperial Legislative Council in 1896. He said : 'I deprecate the way in which these quinquennial revisions have too frequently been carried out. The provincial sheep is summarily thrown on its back, close clipped and shorn of its wool and turned out to shiver till the fleece grows again. ...The normal history is this : two years of screwing and

[1] See Cmd. 4360 (1908) par. 58.

saving and postponement of works, two years of resumed energy on a normal scale, and one year of dissipation of balances in the fear that, if not spent, they will be annexed by the supreme Government at the time of revision.'[1] Finally, the quinquennial settlements crystallized the financial inequalities started in 1871, as no attempt was made in them to bring the provincial expenditure on to a common footing of equality.

Quasi-permanent Settlement (1904)

The year 1904 witnessed an important departure—the introduction of quasi-permanent settlements—in the history of provincial finance. Under this system the revenues assigned to a provincial government were definitely fixed, and were not subject to alteration by the Central Government save in the case of extreme and general imperial necessity, or unless experience proved that the assignment made to the Province was disproportionate to its normal needs.[2]

Broadly speaking, the Government of India received the whole of the revenue derived from opium, salt, customs, mint, railways, posts and telegraphs, the military receipts, and the tributes from Indian States. The revenues derived from registration, ordinary public works, police, education, medical service, courts and jails, were entirely provincial. The receipts from land revenue, excise, stamps, income-tax and forests were divided, venerally in equal proportions, between the Imperial and Provincial Governments. The bulk of the provincial revenues was derived from the divided heads.

Along with this division of revenues there was also a division of expenditure. The Central Government was responsible for all the expenditure in connexion with defence, railways, posts and telegraphs, interest on debts, and home charges. The Provincial Governments were responsible for the whole of the expenditure incurred in connexion with land revenue, general administration, registration, law and justice, police, jails, education, medical services, stationery and printing and provincial civil works.

1 Quoted in Gyan Chand, op, cit., p. 56.
2 See Cmd. 4360 (1908), par. 59.

The expenditures on stamps, excise, income-tax and forests were equally divided, while the incidence of irrigation expenditure followed that of the receipts.[1]

But as the expenditure of the Provincial Governments generally somewhat exceeded the assigned revenues, the difference was made up by three methods :

(i) A fixed assignment, as formerly, under the land-revenue head.

(ii) Initial lump sum grants granted principally with the object of enabling the Provinces to undertake works of public utility.

(iii) Special grants for the development of police reform, agriculture and education.

Another important change with regard to famine expenditure was introduced. Till 1904 the liability for famine relief was provincial and the Government of India only stepped in to help the Provinces when their resources were exhausted. Hereafter a new famine scheme was devised by which the Government of India, year by year, placed a specific amount (roughly calculated with reference to the famine liabilities of each province) on which the Provincial Governments could draw in time of famine without retrenching on their normal resources. When this fund was exhausted the famine expenditure was divided equally between the Central and Provincial Governments; and in the last resort the Government of India promised further help from the Imperial revenues.[2]

On the basis of the budget figures for 1903–4 it was found that the aggregate provincial expenditure represented less than one-fourth of the total expenditure of India as a whole, while the expenditure of the Government of India (which included the expenditure for the army and the home charges) exceeded three-fourths of the aggregate. These proportions of expenditure, subject to some adjustment, were taken as the basis for

[1] Cmd. 4360 par. 61.

[2] Cmd. 4360 par. 61. In 1917 the arrangement was further simplified and famine expenditure was made a 'divided' head—the expenditure being borne by the Central and Provincial Governments in the proportion of three to one. See Cmd. 9109, par. 108. See also chs. iii, iv and ix.

the division of revenue between the Central and Provincial Government.[1] Thus the following division of revenue and expenditure between the Central and Provincial Governments in the divided heads of revenue was decided upon :

PROVINCE		IMPERIAL	PROVINCIAL
Bengal, United Provinces ...	...	3/4	1/4
Bombay, Madras, Punjab, Burma	...	5/8	3/8
Central Provinces, Assam ...	...	1/2	1/2

The Advantages of the Quasi-permanent Settlements

The quasi-permanent settlements were a great improvement upon the old system of quinquennial revisions. Under the old system the Provincial Governments were always exposed to the uncertainties and risks of an unfavourable settlement at the end of every five years. With this sword of Damocles always hanging over their heads, it was impossible to have a liberal outlook in financial policy. Any regular and systematic plan of provincial development along well-considered lines, under such conditions, was not possible. The new system changed this by giving the Provincial Government a more independent position, and a more substantial and enduring interest in the management of its resources than had previously been possible.[2] The Government of India also improved its relations with the Provincial Governments by avoiding the bitter quinquennial controversies in the assignment of revenues.[3]

Permanent Settlements (1912)

The financial relations between the Central and Provincial Governments were examined by the Decentralization Commission (1909) but the Commission did not propose any radical change in the system. The question, however, received the attention of Lord Hardinge's Government, and the quasi-permanent settlements

[1] Some of these adjustments were: (i) larger assignments to backward Provinces, (ii) special grants for carrying out works of improvement or administrative reforms.

[2] See Cmd. 4360 (1908), par. 60.

[3] In 1904—5 the settlements with the Provinces of Bengal, Madras, Assam and the United Provinces were declared to be quasi-permanent. Bombay and the Punjab obtained quasi-permanent settlements in 1905—6. In 1906 the settement of the Central Provinces was made quasi-permanent. Burma came within the pale of quasi-permanent settlement from 1907.

of 1904 were made into 'permanent settlements' from 1912. The permanent settlements did not introduce any change of principle in the allocation of resources; except that they reduced the fixed assignments and gave the Provinces larger shares in the growing sources of revenue. These settlements continued till the Reforms of 1919 when provincial finance entered on an entirely new phase.

The financial position of the Provinces during the period is shown in Tables I—III on the next three pages.

Defects of the Permanent Settlements

With the Reforms (1919) the *basis* of financial relationship between the Central and Provincial Governments underwent a radical change. Till 1919 there was the 'statutory hypothecation of all Indian revenues to all-India needs'.[1] The Provincial Governments could not claim any of the revenues, though raised within their jurisdiction, as entirely belonging to them. Before, however, we discuss the changes brought about by the Reforms, it is worth while to mention some of the chief defects of the then existing system. Three defects of the system stand in prominence :

(i) The strict control and supervision by the Central Government of provincial expenditure.

(ii) The complete control by the Central Government of all taxation raised in British India.

(iii) And lastly, the Provincial Governments had no independent powers of borrowing.

The strict control by the Government of India in the *details* of provincial expenditure was due to the fact that through all the stages of financial evolution from 1833 to 1919, the financial settlements *were based not on provincial revenues but on provincial needs.* This inevitably led to a close supervision from the Central Government because 'the Government of India could not allow a province to go bankrupt'.[2] Moreover, as the Government of India took a share in the divided heads of revenue, its share in the revenues was dependent upon its own competing needs and the needs of the Province. Thus there was a distinct desire of the Government of India to keep down provincial expenditure.

[1] See Cmd. 9109 (1918). p. 93. [2] Ibid., p. 92.

TABLE I

PROVINCIAL SURPLUSES AND DEFICITS

(IN RUPEES)

PROVINCES	1904–5	1905–6	1906–7	1907–8	1908–9	1909–10	1910–11	1911–12
Central Provinces[1] ...	– 7,01,000	32,35,000	17,50,607	– 9,30,617	– 30,97,865	7,21,755	2,80,556	12,14,573
Burma	– 15,91,796	– 26,13,890	18,90,516	– 31,29,590	– 20,60,678	25,15,371	19,00,297	– 12,60,040
Assam[2]	– 2,69,316	– 37,20,027	– 2,00,140	– 25,96,682	– 23,57,687	5,49,270	55,39,698	52,18,802
Bengal	– 12,52,818	– 19,52,312	– 18,77,455	– 22,56,994	– 13,30,371	32,74,065	39,60,612	82,96,233
United Provinces ...	– 8,69,099	– 28,79,192	7,95,600	– 35,87,066	– 10,07,260	20,45,221	36,35,904	1,44,240
Punjab	47,94,387	– 27,96,052	– 6,61,214	– 24,08,818	– 15,76,981	13,00,559	41,99,121	33,98,055
Madras	– 14,02,344	2,20,328	12,17,745	– 44,992	20,25,109	12,66,326	23,16,383	29,38,502
Bombay	43,96,000	– 42,892	17,52,202	– 3,08,925	– 26,71,996	71,37,996	75,85,460	– 5,41,411

1 Includes Berar since 1906.

2 Eastern Bengal and Assam since 1906.

TABLE II

IMPERIAL GRANTS-IN-AID TO THE PROVINCES

(IN RUPEES)

PROVINCES	1904—5	1905—6	1906—7	1907—8	1908—9	1909—10	1910—11	1911—12
Central Provinces[1] ...	28,53,710	69,57,793	1,10,500	27,52,010	29,03,668	35,88,270	34,65,500	20,80,845
Burma	5,67,500	18,45,000	72,19,000	6,82,000	2,15,253	18,20,952	42,32,742	36,05,164
Assam[2]	...	33,62,916	3,27,294	2,80,030	23,58,947	44,64,435	46,08,965	61,00,732
Bengal	24,794	48,06,984	4,75,548	13,62,634	41,57,393	57,53,692	61,37,013	1,11,31,276
United Provinces ...	1,36,600	40,36,307	76,41,697	98,79,667	87,70,345	16,24,329	45,13,729	31,36,107
Punjab	75,26,436	24,67,579	42,09,531	55,41,529	60,37,990	58,39,014	95,92,844	31,01,681
Madras	7,00,946	44,30,714	99,80,400	94,73,304	7,04,885	6,13,941	36,91,426	50,08,889
Bombay	1,03,12,928	34,27,325	40,24,512	45,74,284	57,26,162	57,97,603	1,20,09,360	49,35,159
Total ...	2,21,22,914	3,13,34,618	3,49,82,982	3,45,43,458	3,08,74,643	2,95,02,236	1,54,75,360	3,90,99,853

1 Includes Berar since 1906.

2 Eastern Bengal and Assam since 1906.

Table III

PROVINCIAL SURPLUSES AND DEFICITS

(IN RUPEES)

PROVINCES	1912–13	1913–14	1914–15	1915–16	1916–17	1917–18	1918–19
Central Provinces	50,85,246	18,81,245	– 65,44,416	– 13,836	42,35,704	48,70,517	92,01,121
Burma	88,74,174	9,14,026	– 37,29,808	18,96,621	94,27,702	1,20,67,708	48,73,587
Assam	36,10,494	– 22,17,691	– 45,50,789	6,58,812	60,44,904	28,00,634	4,35,872
Bengal	1,47,05,270	4,80,842	– 39,67,607	10,28,156	37,08,838	52,80,082	7,32,237
Bihar and Orissa	70,22,199	– 9,20,062	– 18,70,264	11,33,562	59,19,907	71,76,786	36,43,564
United Provinces	95,88,749	50,704	– 46,11,080	– 9,73,090	34,27,808	– 22,68,311	36,86,945
Punjab	74,11,069	– 6,92,512	– 37,30,641	– 11,33,541	5,00,995	– 6,95,216	11,85,930
Madras	43,30,275	– 52,98,411	– 12,07,754	3,18,508	25,71,241	10,42,303	– 9,72,354
Bombay	70,83,281	15,58,566	– 26,39,924	– 9,51,099	1,22,434	6,11,321	16,81,066

Similarly, in raising revenues the Government of India had to interfere in details of provincial administration to see that its share was not diminished by the negligence or inefficiency of provincial administration. Such an arrangement was clearly incompatible with the spirit of the reforms. 'The existing settlements', observed the authors of the reforms, 'are an undoubted advance upon the earlier centralized system, but they constitute no more than a half-way stage. If the popular principle is to have fair play at all in Provincial Governments, it is imperative that some means be found of securing to the Provinces entirely separate revenue resources.'[1]

Again, the Provincial Governments had no independent powers of taxation. Section 79(3) (*a*) of the Government of India, Act (1915) prohibited a Provincial Government, without the previous sanction of the Government of India, from considering any law, affecting the public debt of India, or the customs duties or any other tax or duty for the time in force and imposed by the authority of the Governor-General in Council for the general purposes of the Government of India. A proposal for provincial taxation required the sanction of the Government of India, the approval of the Secretary of State, and the assent of the Finance Department before it could be considered by the Provincial Government. The main argument in defence of the then existing system was thus expressed in the Reforms Report (1919) : 'If many buckets are dipping into one well, and drought cuts short the supply of water, obviously the chief proprietor of the well must take it upon himself to regulate the drawings.'[2] Here again, with the increased measure of independence which followed in the wake of the reforms it was inevitable that the Provinces should be given fresh sources of income to pursue their own development policies.

Lastly, the Provincial Government had no power of borrowing in the open market—a restriction which was accepted 'as almost an axiom of the Indian financial system'.[3] It was rather an anomalous position that while Port Trusts and Corporations could raise loans on their securities, the Provincial Governments,

[1] Cmd., 9109 (1913) p. 93. [2] Ibid., pp. 93–4. [3] Ibid., p. 94.

on account of the legal fiction that the revenues of India were 'one and indivisible', could not borrow on their own account. This feature of the financial system was also changed with the introduction of the Reforms. To these matters we return in the next chapter.

Conclusions

How far were the principles of efficiency, suitability and adequacy, it may be asked, observed in the financial settlements during this long period, 1833-1919 ? In answering this question it is well to keep in mind that the provincial financial system was closely bound up with the constitutional machinery of the country. The Indian Mutiny marks the beginning of a new era in Indian constitutional and economic life. Before the Mutiny, the East India Company was engaged in conquering and consolidating the British Empire in India. The need for centralization, for political and military reasons, during this period, was therefore paramount. The principles of public finance could not therefore be given full scope in the machinery of provincial finance. All that the Company was interested in was to administer the conquered territories with as great efficiency as possible. Financial problems were subordinate to military and political problems.

With the passing of the Company to the Crown new economic and financial problems arose. During the latter half of the nineteenth century the road system was vastly improved and extended and the railway construction was planned and developed in a systematic way so as to serve the whole of India. The general economic development of the country resulted in an excessive financial burden on the state. (At first there was no apparent chance of earning immediate profits from the railways or other works of the Public Works Department.) Hence there was a regular and heavy annual deficit which made it clear that it was urgent to reform the provincial financial system. That the principles of efficiency, suitability, and adequacy could not be fully introduced was due to the fact that the entire responsibility for the raising and spending of provincial revenues could not be entrusted to Provincial Governments. (Before 1919 legally all the

revenues of the Provincial Governments belonged to the Government of India.)

However, beginning with a highly centralized system of finance, each step in the financial decentralization was marked by an effort to enlarge the powers and responsibilities of the Provincial Governments in financial administration. The history of financial devolution in India points to one unmistakable conclusion, namely, that in a continent like India, administration, whether political or financial, in the interest of efficiency needs to be decentralized. With the small beginning of budgets by 'assignments' for a few departmental heads, we passed through the system of budgets by 'assigned' revenues, 'quasi-permanent settlements' and ultimately 'permanent settlements'. At each stage a further step in financial decentralization arose out of the need to secure efficiency, economy and responsibility. Opinions may differ as to the length of the period for which each particular system lasted, but it can hardly be challenged by any critic that each step was an essential inevitable stage in the financial devolution of the country. Moreover, it is worth remembering that though high hopes were entertained at each stage, nobody ever pretended that the system had reached the final stage.[1] Financial devolution has *pari passu* followed the constitutional development of the country. The extent of the transformation can best be realized by the fact that while before 1870 the Governor of Bengal could make 'no alteration in the allowances of public servants. . . establish a new school or augment the pay of a *daroga* (a police officer) to the extent of a rupee',[2] in 1919 the same authority could spend crores of rupees without previous reference to the Government of India.

The object of the next chapter is to examine the changes brought about by the Reforms of 1919.

[1] Even Lord Curzon, who always entertained very high hopes from his arrangements, on the occasion of the budget debate in the Imperial Legislatibe Council (1904) used the following guarded language on the financial settlement of 1904: 'These new settlements constitute, in my view, the most important step in the nature of decentralization that has been adopted for many years, and will, I hope, be the forerunner of others in the future.' See *Proceedings of the Governor-General's Legislative Council,* March 30, 1904, p. 547. (India Office Library.)

[2] *The Calcutta Review,* Vol. III, 1945, p. 170.

III

THE MONTAGU-CHELMSFORD REFORMS

§1. *THE CONSTITUTIONAL BASIS*

The Introduction of Limited Responsible Government

The announcement of August 20, 1917, by Mr. Montagu, the Secretary of State for India, declared that the policy of His Majesty's Government was that of increasing association of Indians in every branch of administration and the gradual development of self-governing institutions with a view to the progressive realization of responsible government in India as an integral part of the British Empire.[1] In consonance with this view Mr Montagu visited India in November, 1917, and the Montagu-Chelmsford Report on Constitutional Reforms was issued on April 22, 1918.[2] After a most elaborate examination of the Report by the Joint Select Committee of the two Houses of Parliament which sat on the Reforms Bill, the Government of India Act, 1919, was passed.

The Reforms mark the end of one epoch and the beginning of a new one. Before the Reforms India was ruled by an absolute system of Government; the Provincial Governments being subordinate to the Central Government in executive, financial and legislative spheres, whilst the Central Government itself was under the control of the Secretary of State for India in these matters. Besides this, the Provincial Governments were not responsible to the Provincial Legislatures. No really responsible Government in the Provinces could be introduced without completely changing these relations. Thus, the first thing which the authors of the Reforms aimed at was to curtail the powers of the Government of India over Provincial Governments in legislative, financial and administrative matters. The authors of the Joint Report well observed:

1 *Report on Indian Constitutional Reform*, Cmd. 9109 (1918), p. 5.

2 Cmd. 9109.

> We have to demolish the existing structure, at least in part, before we could build the new. Our business is one of devolution, of drawing lines of demarcation, of cutting long-standing ties. The Government of India must give and the Provinces must receive; for only so can the growing organism of self-government draw air into its lungs and live.[1]

'Central' and 'Provincial' Subjects, 'Reserved' and 'Transferred' Subjects

The Reforms introduced limited responsible government in the Provinces. It classified subjects into 'central' and 'provincial'. Among the important central subjects were military matters, foreign affairs, tariffs and customs, railways, posts and telegraphs, income-tax, currency, coinage and public debt, commerce and shipping and civil and criminal law.[2]

To introduce a measure of limited responsibility, provincial subjects were classified as 'reserved' and 'transferred'. The reserved subjects included land revenue, police, prisons, factory inspection, labour matters in general and administration of justice. In the transferred subjects were placed local self-government, education, sanitation, public health, hospitals, asylums, public works, development of industries, agriculture, veterinary questions and co-operative societies. Broadly speaking, the administration of justice, law and order, and the preservation of financial stability were reserved subjects, and what are loosely called the 'nation-building' departments were transferred.

The Administration of Transferred and Reserved Subjects

The administration of the transferred subjects was placed under the charge of ministers chosen by the Governor from among the elected members of the Provincial Legislative Council. The ministers, together with the Governor, administered these subjects. Under the Act[3] the Governor was to be guided in relation to these

[1] Cmd. 9109 (1918), p. 101.

[2] The actual division of subjects was carried out by the *Devolution Rules* made under section 45A of the Government of India Act, 1919. The Devolution Rules delimited the provincial field in legislative, administrative and financial matters. The Rules were issued as Cmd. 891 of 1920.

[3] Section 52 (1) and (2).

subjects by the advice of his ministers unless he thought that their policy would adversely affect the interests of race, religion, education and other subjects. In such cases he could disregard their advice, and if the ministers did not act according to his advice he could himself assume charge of the subject.[1] He could also sanction any expenditure necessary for any department or for the maintenance of the peace and tranquillity of the Province.

The position of the Governor *vis-a-vis* ministers was subject to severe criticism by both the ministers and the Councils.[2] Thus it was said that the ministers had no real power and were constantly overruled by the Governor. Indeed, it was said the Governor ran the transferred departments as well as the reserved departments. On the other hand there is evidence that the Governor's relations with his ministers were harmonious. 'We have it on record that in one Province the Governor's power of overruling the ministers was never used at all; in another a minister asserted that during the eight years he was minister, there had not been a single occasion when he had been overruled by the Governor.'[3]

Perhaps both these views are extreme views. Appadorai is correct that 'the Governor's experience, and the prestige attaching to his position often enabled him to deflect the course of administration and to have a real voice in the affairs of the transferred half. He maintained a central position not always merely as arbiter or reviser, but as the final repository of administrative experience.'[4] If we accept dyarchy as a transitional stage to full responsible government, the position of the Governor *vis-a-vis* ministers, is, I think, the logical outcome of such an arrangement.

The reserved subjects were administered by the Governor and his Executive Council. The Governor normally presided over the meetings of the Executive Council and in case of a difference of opinion the decision of the majority prevailed, subject to the qualification of the provision under section 50(2).

The position of the ministers was that they were members of the Executive Government but not of the Executive Council.

1 The defects of dyarchy are discussed in ch. iv.
2 See Appadoral, A., *Dyarchy in Practice* (Longmans) 1937, ch. viii.
3 Ibid., p. 233.
4 See Cmd. 3568 (1930), p. 302.

They held office not at the will of the Council but during the Governor's pleasure.[1] The Legislature, however, could censure their administration, reduce their salaries and refuse supplies.[2] The ministers had then to satisfy two masters, the Legislature and the Governor, and in some cases could not satisfy either of them.

The Principle of Joint Responsibility

Within the limits of transferred subjects the principle of joint ministerial responsibility was the intention of the Joint Report. The principle however was nowhere mentioned in the body of the Act. Yet in the working of the Provincial Councils the principle was recognized by the ministers in Madras, the United Provinces and Bengal. It was largely dependent upon the personal equation of the ministers.[3]

This system of government in the Provinces was popularly called Dyarchy.[4]

Local Self-Government

Besides these changes in the administration of the Provincial Governments, the Reforms laid emphasis on the development of local self-government.[5] After reviewing the history of local self-government and the constitution of local bodies as it then existed (1919), the Indian Statutory Commission remarked that outside a few municipalities, there was in India nothing that we should recognize as local self-government of the British type before the era of the Reforms.[6] It is of the highest importance to

[1] Cmd. 5368 (1930), p. 235.

[2] In the Central Provinces in 1924-5, the ministers' salaries were fixed at the farcical figure of Rs. 2 per annum. The Swarajist majority also refused all the supplies which lay in its power to vote. See *The Moral and Material Progress of India* (Government Press, Delhi) 1924–5, p. 304.

[3] See ch. iv. for joint responsibility.

[4] In Bengal in August, 1927, the Provincial Council passed a vote of no-confidence against Mr. (later Sir) A. K. Ghaznavi. Mr. Chakravarti on the principle of joint responsibility resigned as well. The Bengal Council refused to recognize the principle of joint responsibility and passed a separate resolution of non-confidence against Mr. Chakravarti in spite of his assurance that he would resign on account of the non-confidence motion against Mr. Ghaznavi.

[5] The problems of local taxation are discussed in ch. x.

[6] See Cmd. 3568 (1930), 302.

bear this in mind in appraising the changes introduced by the Reforms.

The authors of the Joint Report in formulating the principles for the realization of responsible government laid down their first formula, that: *There should be, as far as possible, complete popular control in local bodies and the largest possible independence for them of outside control.*[1]

Translating this into practice they suggested an elected majority on all boards, the replacement of official chairmen by elected non-officials on municipalities and, where possible, on district boards. The enlargement of the elected element was to be by the extension of the franchise to make constituencies really representative of the general body of rate-payers. The report in particular laid stress on the advisability of fostering village government by *panchayats.* It recommended that *panchayats* might be endowed with civil and criminal jurisdiction in petty cases, some administrative powers as regards sanitation and education, and permissive powers of imposing a local rate.[2]

Since the Reforms, local self-government both in cities and rural areas, though in some cases it showed signs of deterioration, made considerable progress. Generally speaking, the functions entrusted to municipalities are the administration of education, public health, sanitation, medical relief and public works, including roads and bridges. Similarly, district boards control rural education, dispensaries, sanitation, country roads, bridges, water supply, pound, fairs, ferries and *sarais* (rest-houses).

Municipalities enjoyed a considerable measure of freedom with regard to taxation.[3] Draft rules under section 10 (3) (*a*) of the Government of India Act, 1919 empowered the Legislative Council of a Province, without the previous sanction of the Governor-General, to make and take into consideration any law

1 See Cmd. 9109 (1918), p. 155.

2 See Cmd. 9109 (1918), p. 161.

3 The main sources of income of district boards is a tax or cess on the annual value of land. They also receive grants from the Provincial Governments for particular services. See ch. x.

imposing or authorizing any local authority to impose, for local purposes, the following taxes :

(1) A toll.
(2) A tax on land or land values.
(3) A tax on buildings.
(4) A tax on vehicles or boats.
(5) A tax on animals.
(6) A tax on menials and domestic servants.
(7) An octroi.
(8) A terminal tax on goods imported into local areas on which an octroi was levied on or before July 6, 1917.
(9) A tax on trades, professions and callings.
(10) A tax on private markets.
(11) A tax imposed in return for services rendered, such as:
  (*a*) a water rate,
  (*b*) a lighting rate,
  (*c*) a scavenging, sanitary or sewage rate,
  (*d*) a drainage rate,
  (*e*) fees for the use of markets and other public conveniences.[1]

The Government's control in financial matters of local authorities was limited. It could, however, alter their budgets if it considered that they had not made due provision for loan charges, for the maintenance of a working balance or, in other cases, of gross financial negligence. It could also intervene in the administration of local authorities by way of preventing or initiating action in matters affecting human life, health, safety or public tranquillity. But these powers were very infrequently exercised.[2]

§2. *THE CHANGES IN THE FINANCIAL SYSTEM*

Abolition of Divided Heads

An essential and important feature in the political development of a country is the extent of growth in the control over the finances by the people. In chapter II we have seen that one of the defects of the financial system before the Reforms was the

[1] See Cmd. 891 (1920), pp. 36-7.
[2] See Cmd. 3568 (1930), p. 305.

absolute control, and interference, of the Central Government in provincial financial matters. It would have been ridiculous to introduce provincial autonomy without separating the resources of the Central and Provincial Governments, because the existing system of divided heads meant joint control and interference from the centre. The authors of the Report rightly observed:

> The present settlements by which the Indian and Provincial Governments share the proceeds of certain heads of revenue, are based primarily on the estimated needs of the Provinces, and the Government of India disposes of the surplus. This system necessarily involves control and interference by the Indian Government in provincial matters. An arrangement which on the whole worked successfully between two official governments would be quite impossible between a popular and an official govenment.[1]

It was highly important that such troubles should be avoided and the best way to do it was to give the Provinces separate resources. Hence as a preliminary to constitutional reforms the authors of the Report proposed the separation of central and provincial finances. It was justly remarked in the Report that if provincial autonomy was to mean anything real, the Provinces must not be dependent on the Indian Government for the means of provincial development.[2]

'Imperial' and 'Provincial' Sources of Revenue

To this end, Mr. Montagu and Lord Chelmsford proposed to hand over to the Provinces the entire financial responsibility—both in revenue and expenditure—of certain provincial subjects. They abolished the old system of 'divided' heads of revenue. Land revenue, irrigation, excise, forests and judicial stamps, were entirely

[1] Cmd. 9109 (1918), p. 104.

[2] The authors remarked: 'Our first aim has therefore been to find some means of entirely separating the sources of the Central and Provincial Governments.' Cmd. 9109 (1918), p. 164.

The separation, however, was *not* complete, because the Provinces had to contribute a portion of their revenues to the Central Government. I think it hardly need be complete. The 'permanent settlements' before the Reforms provided only for the *ordinary* growth of expenditure, but for large and costly programmes the Provincial Governments had to depend on the doles out of the Indian surplus. See ch. ii.

transferred to the Provinces; while customs, commercial stamps, receipts from railways, salt, opium, posts and telegraphs were to remain wholly central heads of revenue.[1] As a result of this rearrangement the Central Government was faced with a heavy annual deficit of 9.5 crores and the Provincial Governments gained 18.5 crores of additional annual revenue. How to make up this deficit was the chief difficulty of the Committee.

Difficulties in Equitable Provincial Financial Settlements

To remove the deficit the authors of the Report proposed a system of contributions from the Provinces.[2] It was in assessing these contributions that they met with various obstacles on account of the disparity which existed between one province and another in the extent of their revenue and scales of expenditure due to inequalities of treatment in past financial settlements.[3] Apart from such minor difficulties, the unequal economic development of the country was and must always be the most serious handicap in the distribution of resources. India is a huge continent. Some parts of the country are better fitted for industrial advancement on account of the presence of raw materials, sources of power, and of their better geographical position and improved means of transportation and communication. The huge disparity in economic development and financial resources between industrially advanced provinces like Bombay and Bengal, and agricultural provinces like the United Provinces and the Punjab, or the Provinces of Bihar, Orissa and Assam, cannot be corrected by any redistribution of resources even by the most ingenious finance minister. Moreover, the artificial division of the country into various provinces, due to the haphazard growth of British power in India, places insurmountable difficulties in the way of an equitable financial adjustment between the various provinces. In a centralized system of financial allocation and administration, the artificial provincial boundaries were of less importance. But when each Provincial Government, as a result of political advancement, is

[1] For a complete list see *Indian Year Book* (*Times of India*) 1920, pp. 691 ff.

[2] The power to levy such contributions was laid down in s. 112 of the Government of India Act, 1919.

[3] See ch. ii.

made responsible for its own revenue and expenditure, such maldistribution of areas into artificial self-contained units creates additional problems, which are not capable of easy and simple solutions. There can never be in India an absolute equality of treatment of the Provinces in financial resources and adjustments. The aim of the financier must be to minimize such natural and artificial inequalities of burdens and resources to as large an extent as is possible in the light of broad principles of public finance.[1]

Provincial Contributions

The authors of the Report were presented with many a plan for removing the central deficit and minimizing inequalities of provincial financial burdens and resources.[2] Their ultimate choice fell upon a system of contributions from each province based on 'a percentage of the difference between the gross provincial revenue and the gross provincial expenditure'[3] that each province would enjoy under the new allocation of resources. On the basis of the budget figures for 1917–18 (subject to some adjustments) the deficit in the Government of India budget was estimated to be Rs. 1,363 lakhs. The estimated gross provincial surplus (after deducting normal expenditure of all provinces) was Rs. 1,564 lakhs. This left a net

[1] See ch. i and Appendix I.

[2] The various alternative proposals examined by the authors were as follows: 'One way of meeting it would be to maintain the basis of the present settlements, but to allot to the Government of India a certain proportion of growing revenue instead of its share of the divided heads. But this device would stereotype all the existing inequalities between the Provinces which by reason of the permanent settlement in some of them are considerable while it would also introduce an element of great uncertainty into the Indian Government's finance. A second was that we should take an all-round contribution on a *per capita* basis. But this expedient also would not obviate very undesirable variations between provinces in the rate of levy owing to the inequality of provincial resources and of provincial needs. A third plan was to take an all-round percentage contribution based on gross provincial revenue. This is open, *inter alia,* to the objection that it would leave several of the Provinces with large deficits. Fourthly, we considered but rejected the proposal that provinces which had a surplus should temporarily help others as being cumbrous and impracticable.' Cmd. 9109 (1918), p. 168.

[3] The estimated provincial expenditure included provision for famine relief and protective irrigation. Both of these heads were transferred to the Provincial Governments.

surplus of Rs. 201 lakhs available for provincial distribution.[1] Accordingly, each Provincial Government, it was proposed, should contribute 87 per cent of the difference between the gross provincial revenue and the gross provincial expenditure. The provincial contributions and the net provincial surpluses, according to the above principle, are given in the following table.[2]

PROVINCES		GROSS PROVINCIAL REVENUE	GROSS PROVINCIAL EXPENDITURE	GROSS PROVINCIAL SURPLUS	CONTRIBUTION (87 PER CENT OF COL. 4)	NET PROVINCIAL SURPLUS
		IN LAKHS OF RUPEES				
Madras ...	...	13,31	8,40	4,91	4,28	63
Bombay ...	...	10,01	9,00	1,01	88	13
Bengal ...	...	7,54	6,75	79	69	10
United Provinces	...	11,22	7,47	3,75	3,27	48
Punjab ...	...	8,64	6,14	2,50	2,18	32
Burma ...	...	7,69	6,08	1,61	1,40	21
Bihar and Orissa ...	...	4,04	3,59	45	39	6
Central Provinces ...	...	4,12	3,71	41	36	5
Assam ...	...	1,71	1,50	21	18	3
Total	...	68,28	52,64	15,64	13,63	2,01

The authors of the Report, however, admitted the inequality of the burdens and recommended that after ten years' experience of the working of the system the whole question of provincial contributions should be reinvestigated by the Statutory Commission proposed by them.[3]

Criticism of the Basis of the Provincial Contributions

These proposals were severely criticized by the Provincial Governments. The method of assessing the provincial contributions was regarded as highly unfair. The *prima facie* injustice

[1] *i.e.* 13 per cent of the gross available surplus.

[2] See Cmd. 9109 (1918), p. 169.

[3] The weighty words of the authors have not received due consideration at the hands of their critics. The authors fully realized the limitations of their proposals when they wrote. 'We have, for the present, *accepted the inequality of burden* which history imposes on the Provinces because we cannot break violently with traditional standards of expenditure, or subject the permanently-settled Provinces to financial pressure which would have the practical result of forcing them to reconsider the permanent settlement.' Cmd. 9109 (1918), pp. 170, 171. (The italics are mine)

of the scheme can be seen at a glance from the percentages which the contributions would have borne to the net provincial revenues.[1]

Madras	47.7 per cent
United Provinces	41.1 per cent
Bengal	10.1 per cent
Bombay	9.6 per cent

This would have meant that the richest as also the most economical province would have paid the most while the most extravagant province would have paid the least. It would have penalized thrift and encouraged extravagance. In other words, it was really equivalent to putting a premium on extravagance and inefficiency.

The inequality of the treatment seemed to be so apparent that the Government of India in their dispatch of March 5, 1919, pressed for an early treatment of the matter. They proposed the appointment of a committee to advise on financial relations between the Central and Provincial Governments. This recommendation of the Government of India was accepted by the Joint Select Committee of the Houses of Parliament, and the Financial Relations Committee with Lord Meston as its Chairman was appointed in January, 1950.[2]

The Meston Committee

The allocation and distribution of financial resources between the Central Government and the Provincial Governments between 1921–2 and 1936–7, were primarily based on the recommendations of the Meston Committee.[3] A careful study of the Report is extremely important in view of the new basis which the Com-

[1] *i.e.* gross provincial revenue *minus* provincial contribution.

[2] Cmd. 724 (1920).

[3] The Meston Committee was to advise on:

(i) The contributions to be paid by the various Provinces to the Central Government for the financial year 1921-2.

(ii) The modifications to be made in the provincial contributions thereafter with a view to their equitable distribution until there ceases to be an all-India deficit.

(iii) The future financing of the provincial loan account.

(iv) Whether the Government of Bombay should retain any share of the revenue derived from income-tax.

Cmd. 724 (1920), par. 3.

mittee adopted for fixing the provincial contributions. These contributions, popularly known as the 'Meston Award', were largely responsible for the financial stringency in the early years of the working of the Reformed Councils.

The Committee did not favour the distribution of the income-tax proceeds among the Provinces for the two strong reasons advanced in the Joint Report—*first,* the necessity of maintaining a uniform rate throughout the country, and *secondly,* the difficulty of finding out the exact locale of the tax, as in the case of ramifying enterprises the Province where the tax was paid was not necessarily the Province where the tax was earned.

The authors of the Joint Report had divided stamps into two classes—general stamps and judicial stamps: the former they had allocated to the Central Government, the latter to the Provincial Governments. The Meston Committee, in order to help the poorer Provinces, recommended that general stamps should be provincialized. This, they thought, would also remove the last 'taint of a divided head'. Moreover, such an arrangement would facilitate the control and collection by the same agency.

The Meston Award

As a result of the above recommendations for the allocation of the heads of revenue and expenditure between the Central and Provincial Governments, the Committee estimated a deficit of 9.83 crores in the Central budget for the year 1921–2.[1]

[1] (i) Six crores was the deficit previously estimated by the Government of India; to this four crores was added for the loss of general stamps.

(ii) In arriving at the above figure two important adjustments were made:

(*a*) The Burma Government had represented that as 68 per cent expenditure on military police in the Province was incurred for frontier defence, the amount ought to be debited to the Central budget. The Committee accepted this view and recommended that Rs. 17.42 lakhs only should be charged to the Province on this account.

(*b*) The main adjustments, however, were concerned with the payment of pensions. Before the Reforms all civil pensions paid outside India were debited to the Central Government whether the pensioner had served in the Imperial Department or in the Provinces. The Provincial Governments were not charged for such pensions. The Committee recommended that henceforward all pensions paid outside India should be debited to the Province where the pensioner had served. Similarly, the Government of India should pay its own pensioners. Cmd. 724 (1920), par. 10.

The actual distribution of the deficit among the Provinces presented various difficulties to the Committee. The Committee found that the scheme of contributions proposed in the Joint Report, namely assessment proportionate to the gross surplus, was unfair and they accordingly dropped it. The authors of the Joint Report had considered *both revenue and expenditure* in fixing the contributions. Herein lay the main difficulty. While the normal revenue figures, arrived at at the Simla conference, on the basis of which the contributions were fixed, were generally accepted by the Provinces, the estimates of normal expenditure were strongly contested. The Committee were faced with certain contentious questions like these: 'How much of the expenditure held over during the war, or clearly imminent if not already sanctioned, ought to be included in the calculation of normal expenditure? Where is the dividing line to be drawn between expenditure essential in the immediate future, and expenditure foreseen as a future commitment? Ought a province to be penalized by an increase of its contribution for strict adhesion to economy during the war, while another province, which had increased its expenditure more freely, is rewarded by a reduced contribution? Is adequate allowance made for the special conditions of a largely undeveloped province like Burma, or for the circumstances of a recently established province like Bihar and Orissa, which claims that it has never received from its start resources adequate to its needs?'[1] To these questions the Committee could find no satisfactory answers.

Initial Contributions

The Committee, in fixing the initial contribution, made an important departure from the principle laid down by the Joint Report. They dropped altogether the considerations of *expenditure* in fixing the contributions. They fixed the contributions on a new principle, namely that of *the increased spending power of each province under the new allocation of resources.* The Committee, however, in applying this principle placed before it two broad considerations:

[1] See Cmd. 724 (1920), par. 13.

(i) That each province must be left with a certain reasonable working surplus.

(ii) That in no case should the contribution be such as to force the province to embark on new taxation *ad hoc*[1].

In view of the above two limiting considerations the initial contributions were in some measure arbitrarily dictated by the existing financial position of each province and not by an equitable standard such as capacity to pay.[2] Hence the Committee considered the case of each province on its merits and recommended the following assesments, which were accepted by the Joint Select Committee.[3]

INITIAL CONTRIBUTIONS (IN LAKHS OF RUPEES) [4]

PROVINCES		INCREASED SPENDING POWER UNDER NEW DISTRIBUTION OF REVENUE	CONTRIBUTIONS RECOMMENDED BY THE COMMITTEE	INCREASED SPENDING POWER LEFT AFTER CONTRIBUTIONS ARE PAID
Madras ...	...	5,76	3,48	2,28
Bombay ...	...	93	56	37
Bengal ...	...	1,04	63	41
United Provinces	...	3,97	2,40	1,57
Punjab ...	...	2,89	1,75	1,14
Burma ...	...	2,46	64	1,82
Bihar and Orissa	...	51	nil	51
Central Provinces	...	52	22	30
Assam ...	...	42	15	27
Total	...	18,50	9,83	8,67

1 Cmd. 724 (1920), par. 11.

2 'In making our recommendations as to the initial contributions we have had to consider established programmes of taxation and expenditure, and legislative and administrative expectations and habits, that cannot without serious mischief be suddenly adjusted to a new and more equitable ratio of contribution widely different (as an equitable ratio admittedly be) from that of the past. It is accordingly inevitable, if such mischief is to be avoided, that the ratio for initial contributions should bear little relation to that which would be ideally equitable. But an initial ratio of this nature can only be defended as a measure of transition.' Ibid., par. 23.

3 In fixing these contributions, Burma, Bihar and Orissa, the Central Provinces and Assam received special consideration. Burma was lightly assessed on account of its backward condition. No contribution was recorded for Bihar and Orissa for 1921-2 as the Province was the poorest in India in its revenue resources. The Central Provinces and Assam were assessed at 40 per cent because they had a small margin. Bombay, Bengal, the United Provinces and Madras were equally treated and were required to pay 60 per cent of their spending power. Ibid., pars. 18, 19, 20.

4 Ibid., par. 17.

Standard Contributions

The *initial* contributions, which were only transitional, were not considered by the Committee as ideally equitable. In their opinion the standard contributions were to be based on a more satisfactory, equitable and certain basis. They observed that 'to do equity between the Provinces it is necessary that the total contribution of each province to the purse of the Government of India, should be proportionate to its capacity to contribute.'[1]

In translating this principle into practice the Committee were faced with two important considerations. What were the *total* contributions of a province to the revenues of the Central Government? Secondly, and a more difficult question, what were the capacities of the provinces to contribute? With regard to the first question the Committee observed that 'the total contribution of a province to the purse of the Government of India will consist in future of its direct contribution towards the deficit, together with its indirect contribution (as at present) through the channels of customs, income-tax, duties on salt, etc.'[2]

Turning to the second question of an equitable distribution, the Committee stated that 'the capacity of a Province to contribute is its taxable capacity, which is the sum of the income of the taxpayers or the average income of its taxpayers multiplied by their number.'[3]

An evaluation of the amounts of indirect contributions attributable to each province involves an exact arithmetical calculation for which adequate statistical information was not available. Moreover, such information as was available could not be of much use for, e.g., under the head of customs the locality in which the revenue was collected was, surely, not the locality where the articles were consumed. Similarly, under income-tax, questions of the utmost complexity arise, such as the fact that the place

1 Cmd. 724 (1920), par. 24.

2 Cmd. 724 (1920), par. 25. The Committee here were considering the claims of industrial provinces like Bombay and Bengal which contributed the largest share to the Central revenues through customs and income-tax. This question is discussed in ch. iv.

3 Ibid., par. 26. In fixing the second principle the Committee had in mind the claims of poorer provinces like Assam, Bihar and Orissa, whose resources had not fully developed and whose capacity to pay was small.

where the tax is collected is not the true source of the origin. The Committee rightly did not place too much reliance on these factors and in fixing the standard contributions gave due weight to 'the more general circumstances of the economic life of the Provinces'.

The Committee therefore applied the concept of taxable capacity by fixing the contributions with great caution. I cannot do better than quote at length the view of the Committee in this matter. They observed that :

> We are able, after surveying such figures as are available and after close inquiry into the circumstances of each province, to recommend a fixed ratio of contributions which in our opinion represents a standard equitable distribution of the burden of any deficit. In arriving at this ratio we have taken into consideration the indirect contributions of the Provinces to the purse of the Government of India, and in particular the incidence of customs duties and of income-tax. We have inquired into the relative taxable capacities of the Provinces, in the light of their agricultural and industrial wealth and of all other relevant incidents of their economic positions, including particularly their liability to famine. It should be observed that we have considered their taxable capacities not only as they are at the present time, or as they will be in the immediate future, but from the point of view also of the capacity of each province for expansion and development agriculturally and industrially, and in respect of imperfectly developed assets such as minerals and forests. We have also given consideration to the elasticity of the existing heads of revenue which will be secured to each province, and to the availability of its wealth for taxation.[1]

After estimating, to the best of their ability, the weight which should be given to each of the circumstances mentioned above, the Committee recommended the following fixed ratio of standard

[1] Cmd. 724 (1920), par. 27. I have quoted at length the views of the Committee to prove later on that the principles on which the 'award' was based were not unsound. It was the *political machinery* and the *economic conditions* of the times which condemned them. See ch. iv.

contribution which each province should pay to meet the deficit in the budget of the Government of India :

STANDARD CONTRIBUTIONS [1]

PROVINCES	PERCENT CONTRIBUTION TO DEFICIT
Madras	17
Bombay	13
Bengal	19
United Provinces	18
Punjab	9
Burma	6½
Bihar and Orissa	10
Central Provinces	5
Assam	2½
	100

The Committee, in order to avoid sudden dislocation in provincial budgets, further safeguarded their findings by requiring an interval of seven years to enable the provinces to adjust their budgets to new conditions. The initial, intermediate and ultimate ratios of contributions as recommended by the Committee are given in the following table: [2]

PROVINCES	1ST YEAR	2ND YEAR	3RD YEAR	4TH YEAR	5TH YEAR	6TH YEAR	7TH YEAR
Madras	35½	32½	29½	26½	23	20	17
Bombay	5½	7	8	9½	10½	12	13
Bengal	6½	8½	10½	12½	15	17	19
United Provinces ...	24½	23½	22½	21	20	19	18
Punjab	18	16½	15	13½	12	10½	9
Burma	6½	6½	6½	6½	6½	6½	6½
Bihar and Orissa ...	nil	1½	3	5	7	8½	10
Central Provinces ...	2	2½	3	3½	4	4½	5
Assam	1½	1½	2	2	2	2	2½
Total ...	100%	100%	100%	100%	100%	100%	100%

Changes made by the Devolution Rules

These recommendations of the Committee were severely criticized by the public and the Provincial Governments, whose views were invited by the Government of India.[3] The Secre-

[1] Cmd. 724 (1920), par. 27.
[2] Cmd. 724 (1920), par. 28.
[3] The views of the Government of India and the Local Governments are published in Cmd. 974 (1920).

tary of State and the Government of India, however, accepted them. The Joint Select Committee of Parliament, in view of the loud protests of the Provincial Governments, made some changes in revising the Draft Rules made under the Government of India Act, 1919.[1] Accordingly the Devolution Rules provided :

(15) There shall be allocated to each Local Government a share in the income-tax collected under the Indian Income Tax Act, 1918, within its jurisdiction. The share so allocated shall be three pies on each rupee brought under assessment under the said Act, in respect of which the income-tax assessed has been collected. The number of pies to be specified shall be so calculated as to yield at the outset to the Local Governments collectively a sum amounting as near as may be to 400/- lakhs.

(17) In the financial year 1921–2 contributions shall be paid to the Governor-General in Council by the Local Governments mentioned below according to the following scale :

NAME OF PROVINCE	CONTRIBUTIONS (IN LAKHS OF RUPEES)
Madras	3,48
Bombay	56
Bengal	63
United Provinces	2,40
Punjab	1,75
Burma	64
Central Provinces and Berar ...	22
Assam	15

(8) From the financial year 1922-3 onwards a total contribution of 9,83 lakhs, or such smaller sum as may be determined by the Governor-General in Council, shall be paid to the Governor-General in Council by the Local Governments mentioned in the preceding rule. When for any year the Governor-General in Council determines a smaller sum than that payable for the preceding year, a reduction shall be made in the contributions of those Local Governments only whose last previous annual contri-

[1] Section 45 A, Cmd. 891 (1920).

bution exceeds the proportion specified below of the smaller sum so determined as the total contribution; and any reduction so made shall be proportionate to such excess:

Madras	17/90ths
Bombay	13/90ths
Bengal	19/90ths
United Provinces	19/90ths
Punjab	9/90ths
Burma	6½/90ths
Central Provinces and Berar ...	5/90ths
Assam	2½/90ths

Provincial Loan Account

A few more changes, introduced by the Reforms, to complete the separation between the provincial and central finances, need our attention at this stage. First, it was commonly agreed that the Provincial Loan Account should be closed and the Provinces should in future finance their own loan transactions.[1] On the basis of the recommendations of the Financial Relations Committee it was provided by Rule 23 of the Devolution Rules that:

> Any moneys which, on the 1st day of April, 1921, are owed to the Governor-General in Council on account of advances made from the Provincial Loan Account of any Province shall be treated as an advance to the Local Government from the revenues of India, and shall carry interest at a rate calculated on the average rate carried by the total amount owed to the Governor-General in Council on this account on the 31st March, 1921. The interest shall be payable upon such dates as the Governor-General in Council may fix. In addition, the Local Government shall pay to the Governor-General in Council in each year an instalment of the principal amount of the advance, and this instalment shall be so fixed that the total advance shall, except where for special reasons the Governor-General in Council may otherwise direct, be repaid before the expiry of twelve years. It shall be open to any Local Government to repay in any year an amount in excess to the fixed instalment.[2]

1 Cmd. 724 (1920) ch. vi, Provincial Loan Account.
2 Cmd. 891 (1920).

Irrigation under the Reforms

Irrigation under the Reforms scheme, was a provincial reserved subject. It would have been incompatible, under the scheme, to make the Government of India responsible for such expenditure and to hand over the control to the Provincial Governments. Hence Devolution Rule 24 provided that :[1]

> (1) The capital sums spent by the Governor-General in Council upon the construction in the various Provinces of productive and protective irrigation works and of such other works financed from loan funds as may from time to time be handed over to the management of Local Governments shall be treated as advances made to the Local Governments from the revenues of India. Such advances shall carry interest at the following rates, namely:
>
> (*a*) In the case of outlay up to the end of the financial year 1916-17, at the rate of 3.3252 per centum.
>
> (*b*) In the case of outlay incurred after the financial year 1916-17, at the average rate of interest paid by the Governor-General in Council on loans raised in the open market since the end of that year.
>
> (2) The interest shall be payable upon such dates as the Governor-General in Council may fix.

Provincial Borrowings

Prior to the Reforms, as we have already noticed, the power of borrowing was not conceded to the Provinces. The authors of the Reforms clearly recognized that if Provincial Governments were to enjoy such a real measure of independence as would enable them to pursue their own development policy, they must be given some powers of raising loans on the security of their resources. Consequently the Local Government Borrowing Rules, made under the Government of India Act, provided that, subject to certain conditions.[2]

[1] Cmd. 891 (1920).
[2] See Cmd. 891 (1920).

A Local Government may raise loans on the security of the revenues allocated to it for any of the following purposes, namely:

(*a*) To meet capital expenditure on the construction or acquisition (including the acquisition of land, maintenance during construction and equipment) of any work or permanent asset of a material character in connexion with a project of lasting public utility, provided that:

(*i*) the proposed expenditure is so large that it cannot reasonably be met from current revenues, and

(*ii*) if the project appears to the Governor-General in Council unlikely to yield a return of not less than such percentage as he may from time to time by order prescribe, arrangements are made for the amortization of the debt;

(*b*) to meet any classes of expenditure on irrigation which have under the rules in force before the passing of the Act been met from loan funds;

(*c*) for the giving of relief and the establishment and maintenance of relief works in times of famine or scarcity;

(*d*) for the financing of the Provincial Loan Account; and

(*e*) for the repayment or consolidation of loans raised in accordance with these rules or the repayment of advances made by the Governor-General in Council[1] (Section 2).

'Scheduled Taxes'

The authors of the Report clearly saw that for the growth of real provincial autonomy the Provincial Governments must be allowed to impose taxes without the previous sanction of the

1 These rules were subject to the following two conditions: (1) No loan shall be raised by a Local Government without the sanction (in the case of loans to be raised in India) of the Governor-General in Council, or (in the case of loans to be raised outside India) of the Secretary of State in Council, and in sanctioning the raising of a loan the Governor-General in Council or the Secretary of State in Council, as the case may be, may specify the amount of the issue and any or all of the conditions under which the loan shall be raised. (2) Every application for the sanction of the Secretary of State... shall be transmitted through the Governor-General in Council. Cmd. 891 (1920), section 3.

Government of India. Hence by the rules made under the Reforms Act it was provided that :[1]

> The Legislative Council of a Province may, without the previous sanction of the Governor-General, make and take into consideration, any law for imposing for the purpose of the Local Government any tax included in Schedule I.[2]

This schedule comprised the following heads of taxation:

(1) A tax on land put to uses other than agricultural.
(2) A tax on succession or acquisition by survivorship in a joint family.
(3) A tax on any form of betting or gambling permitted by law.
(4) A tax on advertisements.
(5) A tax on amusements.
(6) A tax on any specified luxury.
(7) A registration fee.
(8) A stamp duty other than duties of which the amount is fixed by Indian legislation (Schedule I).[3]

In other cases the previous sanction of the Governor-General in Council was necessary.

Provincial Budgets

Finally, as a result of the proposed separation of revenues a complete separation of the central and provincial budgets came in. Before the Reforms the budget of the Government of India included the transactions of all the Provincial Governments as well. Henceforward, the provincial budget instead of being passed by the Finance Department of the Government of India, was framed by the Finance Department of each province.

Thus was cut the financial, administrative and legislative strand which had so far blocked the path for the growth of provincial autonomy in India.

[1] Rules under s. 10 (3), (*a*) of the Government of India Act, 1919, Scheduled Taxes Rules. Cmd. 891 (1920).
[2] Section 2.
[3] Cmd. 891 (1920).

Conclusion

The Reforms mark the end of the old era and the beginning of a new one. With the introduction of limited provincial autonomy the Central Government's legislative, administrative and financial control in provincial matters decreased considerably. The Provincial Governments were given real freedom to work the Reforms in a limited sphere. The transfer of financial control was perhaps the greatest line of advancement. Nevertheless, the Reforms were regarded as a niggardly gift and a sham. The critics 'termed them a dress giving only the trappings of reality to a dead body which had neither life nor force'.[1]

This, however, is an extremely shallow view of the Reforms. Every student of Indian problems, whatever his prepossessions, must be driven by the inexorable force of facts to recognize that the Reforms were a transitional stage in the constitutional evolution of the country. From the Reforms did emerge a steady, though slow, process of administrative devolution from the Government of India to the Provincial Governments, which has profoundly affected the whole course of India's future constitution. This gradual devolution produced three important results. 'It had tended to remove provincial administration from the immediate purview of His Majesty's Government and, by thus weakening the direct accountability of Indian administrators to Parliament, it had, perhaps, rendered inevitable the introduction, in some degree, of local responsible government. At the same time, it had tended to make the Provinces the centres of the development of social services; and it had also tended to transfer to the Provincial Executives the prime responsibility for the preservation of law and order.'[2] It is these changes which led to the abolition of dyarchy and to the introduction of provincial autonomy in 1937.

[1] Speech of Lord Reading to the Joint Session of Indian Legislatures, July 28, 1923.

[2] See *Joint Committee on Indian Constitutional Reforms* (1933-4), Vol. I, Part I, p. 9.

IV

THE MESTON SETTLEMENT AND ITS RESULTS

The division of public revenues among the different Provincial Governments covering a very wide geographical area is an extremely difficult problem in India. Under the highly centralized system of administration before the Reforms the division of financial responsibilities was comparatively simple. But with the introduction of responsible government the equitable distribution of burdens and resources was no longer an easy matter. The same forces which promoted decentralization of governmental functions demanded decentralization of tax administration. The task of the Meston Committee was highly difficult. For a proper understanding of the working of the Meston Settlement it is essential that we take into consideration the defects of dyarchy as well as the unforeseen economic circumstances under which the system was introduced. Hence we may divide the issues into three parts:

(i) The working of dyarchy and its financial effects.

(ii) The unforeseen economic circumstances and their effects on the working of the Meston Settlement.

(iii) An examination of the principles of the allocation of revenue and expenditure between the Central and Provincial Governments and between the Provinces *inter se*.

§1. *THE WORKING OF DYARCHY*

The Administration of Reserved and Transferred Subjects

The outstanding feature of government in the Provinces under dyarchy was the division of the administration into two distinct spheres—the 'transferred' and the 'reserved' halves of the Government. The theory of the dyarchic constitution was to make the ministers jointly responsible to the elected legislature in respect of the transferred half of the Government. But in the actual working of the constitution it became impossible to translate this

theory into practice.[1] In their evidence before the Reforms Enquiry Committee the majority of the ex-ministers pointed out that they were dealt with by their Governors individually and not collectively. In other words, 'there were ministers but no ministries'. The growth of the principle of joint responsibility was largely dependent upon the personal equation of the ministers.[2]

The unhappy political circumstances under which the Reforms were started made it impossible for the ministers to secure an elected majority. The ministers were largely dependent on the support of the official bloc and were generally regarded as 'Government men'. Their policy was considerably influenced by the reserved side of the Government with the result that the ties between the ministers and their supporters weakened.

The failure to establish 'joint responsibility' on the transferred side further resulted in a loss of support and confidence of the provincial legislatures and ultimately impeded the conduct of business.

Again, the Act made no provision for joint deliberation between the two halves of the Government. The actual practice followed differed from province to province. In the United Provinces in the beginning 'there were weekly meetings of the whole Government'; such meetings generally became less frequent as time went on. In Madras, joint deliberation between the two halves of the Government was laid down as an essential feature and it exercised a wholesome influence in the working of the constitution.

The absence of joint deliberation gave rise at times to friction and feelings of mutual distrust between the ministers and the executive councillors, which were not conducive to efficient and good administration.

The success in the working of dyarchy was largely due to the dominant influence of Governors in harmoniously combining the interests of the two halves of the Government. The precise extent to which dyarchy succeeded is different from province to

[1] See chs. iii and v.

[2] 'The evidence of Mr. Chitnavis and Rao Bahadur Kelkar of the Central Provinces, of Lala Harkishenlal of the Punjab, and of Sir P. C. Mitter of Bengal, shows that not only did the Governors deal with their ministers separately but the latter, in some provinces at any rate, themselves did not observe the convention of joint responsibility.' *Report of the Reforms Enquiry Committee: Minority Report,* p. 154. Cmd. 2360 (1925).

province. Its success even in the same province is different from time to time with the personal equation of the Governors.

Joint or Separate Purse

Before the inauguration of the Reforms, the question of the Joint or Separate Purse loomed large in public discussions. There was much discussion as to whether the revenues of a province should be treated as one single fund out of which funds should be allocated to the two halves of the Government, or whether in view of the dyarchic constitution, the transferred departments should have their own separate funds distinct from the resources available to the reserved departments. The authors of the Reforms proposed that the provincial budget should be framed by the executive Government as a whole. The first charge on provincial revenues was to be the provincial contribution to the Government of India; after that the supply for the reserved subjects was to have priority. Lastly, the allocation of supply for the transferred subjects was to be decided by the ministers, who were, with the Governor, also to decide the question of new taxation, if the revenues were insufficient.

These proposals were criticized by the Government of India on the ground that such a procedure for the allocation of revenues would create friction between the two halves of the Government. Nevertheless, they finally came to the conclusion that it was advisable to divide the revenues between the two halves of the administration and hence they recommended the method of separate purses.

The Joint Select Committee, however, expressed its preference for a 'joint purse', and this arrangement was ultimately adopted in the Devolution Rules. Consequently, in each Governor's Province, under the Reforms, the budget was framed by the Finance Member, who belonged to the reserved half of the administration.

It is commonly supposed that this arrangement was a serious difficulty in the working of the Reforms. This, however, was not the cause. The allocation of revenues between the transferred and reserved subjects was decided by an agreement between the ministers and the Finance Member. Dr. Gangulee is hardly correct

when he says that 'this proved to be a serious handicap to the ministerial position, and in every province this financial arrangement not only led to considerable friction but to a certain amount of irresponsibility in both the halves of the Government'.[1] The actual difficulty was the financial stringency which did not leave enough surplus funds for the ministers to develop 'nation-building' departments. The system of separate purses would probably have aggravated the difficulties instead of mitigating them.[2]

The Defects of Dyarchy

The defects of the working of dyarchy were brought into relief by the Reforms Enquiry Committee, generally referred to as the Muddiman Committee.[3] Most of the Provincial Governments and ministers who had worked the Constitution condemned the working of the system. 'It was a common cry', said the Bengal Government, 'that the transferred departments were being starved at the expense of the reserved departments. It was no wonder that when, under the reformed system, the popular ministers were unable through lack of money to produce and carry out schemes of development in education, public health and the like, the system has been condemned in many quarters.'[4]

Dyarchy, in the words of the Governor of the United Provinces, is obviously a cumbrous, complex, confused system, having no logical basis, rooted in compromise, and defensible only as a transitional expedient.[5]

The Minister of Industries in Madras gave his experience of dyarchy in the following words:

1 Gangulee, N., *The Making of Federal India* (Nisbet) 1936, p. 51.

2 *The Reforms Enquiry Committee* (*Majority* and *Minority*) were both in favour of 'joint purses'. See *Majority Report,* pp. 92-3; *Minority Report,* p. 168: Cmd. 2360 (1925). The Simon Commission also favoured 'joint purse'. See Cmd. 3568 (1930), par. 397.

3 *The Reforms Enquiry Committee,* under the chairmanship of Sir Alexander Muddiman, was appointed by Mr. Ramsay MacDonald. The Committee issued two Reports—a Majority Report and a Minority Report. The report of the Committee is instructive as it contains the views of several ex-ministers who had actually worked the Constitution. *Report,* Cmd. 2360 (1925). The views of the Local Governments are given in Cmd. 2361 and 2362 (1925).

4 Cmd. 2362 (1925), p. 140.

5 Ibid., p. 168.

'I am Minister of Development minus forests, and you all know that development depends a good deal on forests.[1] I am Minister of Industries without factories, which is a reserved subject, and industries without factories are unimaginable. I am a minister of agriculture minus irrigation. You can understand what that means. How agriculture can be carried on extensively without irrigation in the hands of those who are responsible for it is rather hard to realize. I am also Minister of Industries without electricity, which is also a reserved subject. The subjects of labour and boilers are also reserved.'[2]

From the foregoing account it is clear that the defects of dyarchy, caused partly by political difficulties, such as the lack of co-operation on the part of Swarajists, partly by the absence of joint responsibility and joint deliberation—resulted in an atmosphere of mistrust and suspicion which damped the enthusiasm and energies of the ministers.[3] This reacted on the financial policy, and the Meston Settlement was condemned in unequivocal terms everywhere.

§2. *THE EARLY FINANCIAL DIFFICULTIES IN THE WORKING OF THE MESTON SETTLEMENT*

The Unforeseen Economic Circumstances

A common fallacy in the treatment of the problems of provincial finance in India is to regard the financial problems of the Central and Provincial Governments as entirely separate. Under the Reforms the system of central and provincial finance, though separated as book accounts, was largely interconnected and interdependent. The unsatisfactory position of the Government of ings and the high expenses of the frontier disturbances, largely losses on account of exchange difficulties, lowered railway earnings and the high expenses of the frontier disturbances, largely aggravated the difficulties of the Provincial Governments in the successful working of the Reforms.

[1] Forests was a 'reserved' subject except in Bombay where it was transferred'.

[2] Cmd. 2362 (1925), p. 109.

[3] The Swarajists pledged themselves to a policy of uniform, continuous and consistent obstruction, with a view to making government, through the Assembly and the Provincial Councils, impossible.

Heavy Central and Provincial Deficits

The Central Government was passing through a period of exceptional financial stress and strain. For five years in succession (1917-22) there was a deficit budget. The accumulated total deficit at the close of 1922-3 was no less than Rs. 100 crores, in spite of the additional heavy taxation. In two years, 1921-3, the Central Government imposed 23 crores of new taxation, apart from increased railway and postal charges. In 1923-4, the Government of India was again faced with a deficit of 4.5 crores which led to the increase of the salt duty to Rs. 2-8 per maund. Out of the total deficit of 100 crores, 31 crores was met by the creation of paper money, which represented nothing but the IOU.s of the Government of India. The remaining 69 crores was raised by borrowing and the issue of Treasury Bills.[1]

The Provincial Governments were also passing through a period of financial distress. In March 1922, Lord Hailey put the excess of provincial expenditure over revenue at eight crores of rupees. The result was that most of the Provincial Governments were living on their balances, which were reduced from sixteen crores in 1921 to only five crores in 1922. Some of the provinces had exhausted their balances, while others were living on borrowed balances.[2]

The Difficulties in the Early Abolition of Provincial Contribution

The problem was an all-India one. The abolition or reduction of provincial contributions no doubt would have reduced the provincial deficits but the deficit of the Government of India would have increased. The total quantity of deficit would have been the same—whether we had wholly central or wholly provincial deficits or partly central and partly provincial deficits. The vacuum would have been either at Delhi or in the Provinces.

It was easy to suggest that provincial contributions should cease at once. But the crucial point is what were the alternative methods to restore the budgetary equilibrium of the Central

[1] See the speech of Sir Basil Blackett in introducing the Finance Bill for 1923-4, March 1, 1923.

[2] See the speech of Lord Hailey in introducing the Finance Bill for 1922-3, March 1, 1922.

Government? It would have been impossible to cut down the expenditure by say 20 to 30 crores per annum all of a sudden without a serious loss of administrative efficiency. The difficulties of increased taxation were immense. The best evidence of the difficulty of imposing new taxation is furnished by the Legislative Assembly refusing its assent to increase the salt duty in 1922 and twice again in 1923, even after the Finance Member had gravely assured the House that it was an emergency measure and the only way to financial solvency.[1] The Legislative Assembly still persisted in refusing its assent and the tax was thereupon certified by the Viceroy. Opinions will always differ as to how far Lord Reading was justified in certifying the Finance Bill in 1923. Perhaps the best criticism of the embarrassing situation is given by Dr. Anstey in the following sentences:

'It is difficult to decide how far the very violent opposition to the higher rate of duty was genuine, and how far the incident was utilized as a convenient stick with which to beat the Government at a period when non-co-operation was at its height. It is possible that the burden imposed by raising the tax has been exaggerated, but as the tax undoubtedly does affect the whole population, it ought not to be increased except at a time of urgent financial stress.'[2]

The Meston Settlement was based on the assumption that the deficit of the Central Government at the initiation of the Reforms, to be made good from provincial contributions, would be Rs. 9,83 lakhs. This figure was based upon various assumptions, three of which were of great importance. The first was the two-shilling rate of exchange; the second was a military budget of Rs. 43 crores; and the third was that railways would yield a net

[1] Sir Basil Blackett in his Budget speech, 1923, observed: 'I appeal to the House for one last long and strong pull, all of us pulling together, in the confident assurance that so doing we shall quickly get the boat out of the vicious current which is threatening to drag India down on to the rocks of insolvency. Once back in safe waters, I have every hope that in a surprisingly short time we shall find ourselves on the flood tide of prosperity, and shall be able to turn our minds to pleasant thoughts of reduced provincial contributions, reduced taxation, and increased devotion of our resources to the development of India . . . Let us crown our success by a fourth red-letter day, and end our Session with a balanced budget.' *Speech of Sir Basil Blackett in introducing the Finance Bill, March 1, 1923.*

[2] Anstey, V., op. cit., p. 380.

profit of Rs. 8 to 10 crores per annum. These optimistic calculations were all falsified. Exchange behaved in a most wayward manner, resulting in a loss of no less than Rs. 15.5 crores. The military budget cost more than 20 crores beyond the assumed figure of 43 crores. The revenue from railways was also disappointing, and the receipts owing to trade conditions fell off seriously. With this new situation it was obviously impossible for the Government of India to make a beginning in the reduction of provincial contributions. The increase of further debts would have been a dangerous and disastrous course.[1] To do so would have increased the uncovered deficit of the Central Government, which must inevitably have resulted in the financial insolvency and ultimate ruin of the whole country.

Conclusion

To conclude, the situation as explained above was certainly difficult—much more difficult than most people imagine or care to realize. The Meston Settlement received undue condemnation on account of the series of deficits in Central and Provincial budgets which coincided with the inauguration of the Reforms. With the steady revival in trade and increased prosperity the era of unbalanced budgets disappeared. Sir Basil Blackett's six years of financial leadership saw the rehabilitation of the finances of the Central Government and marked the abolition of the much-talked-of provincial contributions. The Government of India made a real and honest attempt to wipe off the provincial contributions as soon as their financial position improved. Hasty measures in the field of finance always lead to the ditch.

Provincial Contributions (1921-7)

The provincial contributions from 1921-2 to 1927-8 are shown in Table IV on the next page.

[1] 'A large volume of Treasury Bills is an evil in England, where the condition of the money market is such that it is always possible to renew maturing bills by offering a competitive rate, but in India conditions might easily arise under which even an impossibly high rate would be insufficient, and in that case the Government of India would be driven back to replacing the Treasury Bills by paper currency, *i.e.* would be driven to taxation by inflation.'—*Speech of Sir Basil Blackett in introducing the Finance Bill for 1923–4, March 1, 1923.*

TABLE IV

PROVINCIAL CONTRIBUTIONS TO THE CENTRAL GOVERNMENT[1]

(IN THOUSANDS OF RUPEES)

PROVINCES	1921–2	1922–3	1823–4	1924–5	1925–6	1926–7	(b) '27–8
Madras	3,48,00	3,48,00	3,48,00	3,48,00	2,21,98	1,65,19	
Bombay	56,00	56,00	56,00	56,00	34,00	28,00	
Bengal	63,00	(a)	(a)	(a)	(a)	(a)	
United Provinces	2,40,00	2,40,00	2,40,00	2,40,00	1,83,83	1,50,85	
Punjab	1,75,00	1,75,00	1,75,00	1,75,00	1,13,84	85,73	
Burma	64,00	64,00	64,00	64,00	44,35	50,23	
Bihar and Orissa	..	..	..	..	..	..	
Central Provinces	22,00	22,00	22,00	22,00	13,00	22,00	
Assam	15,00	15,00	15,00	15,00	9,00	15,00	
Coorg	..	..	..	12	12	12	
TOTAL ..	9,83,00	9,20,00	9,20,00	9,20,12	6,20,12	5,17,12	

[1] Source: Cmd. 3610 (1930).
(a) Contribution remitted.
(b) The entire amount of the contributions was remitted in 1927-8.

§3. *THE MESTON SETTLEMENT EXAMINED*

The Division of Functions between the Central and Provincial Governments

So far we have considered the defects of dyarchy and their reactions on the working of the financial arrangements. Incidentally we have also mentioned the effects of the unforeseen economic circumstances which coincided with the early years of the working of the Reforms. Lastly, we have to discuss the question as to whether the Meston Settlement was fair and equitable or not.

The usual approach to the problem is to examine the adjustment of Governmental functions to revenues. The ideal distribution of Governmental functions in relation to revenues among competing tax jurisdictions would be to harmonize the yield and elasticity of revenue with the growing needs of the Government. This, however, is rarely done. Hence the functions of overlapping tax jurisdictions always require transfers of funds from one jurisdiction to another.

The problem of financial relationships between the Central and Provincial Governments in India cannot be harmonized on account of constitutional and administrative difficulties. The Montford Reforms were a transitional stage in the constitutional evolution of the country. Under the Reforms scheme the Central Government was mainly responsible for defence, debt services and the commercial departments (railways, posts and telegraphs) of the Government of India. The Provinces were charged with the development of 'nation-building' services. Such a distribution of Governmental activities was entirely due to administrative convenience and political reasons.

The financial allocation of resources was a necessary corollary of the functions assigned to the Central and Provincial Governments. The functions of Government can be arranged in an ascending scale of urgency, ranging from those which concern the comfort and well-being of the individual to those which secure the existence of the State [1]. In every country the Central or Federal

[1] Cmd. 9109 (1918), par. 188.

Government's basic obligation of maintaining the country's defence does not apparently affect or benefit the life of an average citizen; while the activities of the State or Provincial Governments deeply concern his daily life. The average citizen is more interested in the activities of the Provincial Governments which drive out malaria, spread education, provide hospitals and dispensaries and prevent theft, than in the Central Government which keeps out the phantom foreign invader, controls the intricate policy of foreign exchanges, explores regions in the eternal snow of the Himalayas and builds capitals amidst the ruins of empires.[1] Thus the funds of the Provincial Governments require a flow of capital capable of vast expansions to carry out their ever-increasing activities on 'nation-building' departments. But under the new allocation of resources this was not the case. For the rapidly expanding needs of the provinces the sources of revenue assigned were inelastic and insufficient.

The Provincial Sources of Revenue were Inelastic

Land Revenue was the mainstay of provincial finance under the reformed constitution. In permanently settled parts of the country the yield from land revenue is not capable of any appreciable increase. The financial difficulties of Bengal and its claim for special treatment in the fixation and remission of provincial contributions were due to this highly inelastic source of revenue. In other provinces as well, on account of long-term settlements and the changed policy for reducing the burden of the cultivators followed in recent settlements, the increase in land revenue has not kept pace with its earlier yield. Though the net income from land revenue in 1925–6 was Rs. 6,41 lakhs greater than in 1901–2, its percentage in 1925–6 as compared with 1901–2 fell from 42 to 21 per cent of the total net revenue of the Central and Provincial Governments.[2]

[1] Sir Basil Blackett did not favour the huge expenditure on the New Delhi scheme being met out of revenue. See his speech in introducing the Finance Bill, 1923-4.

[2] Anstey, op. cit., p. 368. See also the footnote on the same page for an excellent table showing a comparative view of the change in the relative importance of certain outstanding sources of Indian revenue during 1883-4—1923-4.

The other provincial heads of revenue either required a large capital outlay for their development (e.g. forests) or on account of other reasons were not capable of much expansion. On the whole, the Provincial Governments had inelastic sources of revenue for their rapidly expanding needs.

The Central Sources of Revenue were Elastic

On the other hand the Central Government for its comparatively stationary needs had expanding sources of revenue. The yield of the three sources of revenue, namely customs, income-tax, and salt, can be seen from the following statement:

RECEIPTS FROM CUSTOMS, INCOME-TAX AND SALT[1]

YEAR	CUSTOMS	INCOME-TAX	SALT
	(IN THOUSANDS	OF RUPEES)	
1921-2	34,37,42	22,17,54	5,97,52
1922-3	41,29,24	18,13,94	6,42,36
1923-4	39,64,40	18,49,12	9,63,97
1924-5	45,68,27	16,21,23	7,02,67
1925-6	47,68,09	16,12,04	5,92,69
1926-7	47,28,31	15,98,28	6,31,63
1927-8	48,11,54	15,42,63	6,22,15
1928-9	49,11,89	17,05,64	7,20,43
1929-30	51,12,59	17,06,34	6,36,76
1930-1	46,64,27	16,30,97	6,44,09
1931-2	46,25,49	17,56,95	8,35,52
1932-3	51,67,47	18,00,31	9,83,29
1933-4	46,85,58	17,15,89	8,51,24
1934-5	52,36,50	17,58,04	7,63,67
1935-6	53,77,59	17,09,95	8,06,11

Thus one of the chief defects of the Meston Settlement was that while it made the Provinces responsible for the development of the 'nation-building' activities, the sources of revenue which it placed at their disposal were inelastic. The unpopularity of the Reforms was largely due to the difficulties in finding additional

[1] Sources: Cmd. 3291 (1928), Cmd. 5804 (1938).

sources of revenue.[1] Nor must it be forgotten that for this state of affairs the Provincial Governments were themselves responsible to some extent by not developing some of the sources of revenue suggested by the Taxation Enquiry Committee, e.g. succession duties. No doubt in the early years of the Reforms there was considerable difficulty in imposing increased taxation due to the persistent political opposition, but the atmosphere had considerably improved in the later years of the working of the constitution. The failure to develop new sources of revenue resulted in creating gross inequalities of burdens between the different sections of the community.

The Necessity For Provincial Contributions

The provincial contributions formed an important feature of the Meston Settlement. We must brush aside the common notions about provincial contributions which are widely held in India. The late Mr. Gokhale, one of the strongest advocates for a system of federal finance for India, in his evidence before the Decentralization Commission, outlined a scheme of federal finance in which the provinces were to contribute to the Central Government.[2] Professor Seligman also favoured the system of contributions from the Federal or Central to the State or Provincial

[1] The Muddiman Committee observed: 'It is due to it (*i.e.* the Meston Settlement) that ministers have been unable to enter upon a policy of progressive development in the spheres of administration committed to their care. If they had been able to do so, they would have been able to provide an answer to those critics who have reiterated the allegation that the Reforms were a sham, and they would also have been able to consolidate their position or else have been required to make way for other ministers who could have enunciated a policy more acceptable to the Councils which would incidentally have assisted in the establishment of the responsibility of the ministers to the Councils.' *Report of Reforms Enquiry Committee*, 1924. *Majority Report*, par. 56. Cmd. 2360 (1925).

[2] Mr. Gokhale in his evidence before the Decentralization Commission remarked: 'There should be no divided heads of either revenue or expenditure, but certain heads of revenue with the expenditure under them should be wholly imperial and the others wholly provincial...on this basis of division, the revenues of all the Provincial Governments will be found to exceed their present scale of expenditure, while the reverse will be the case with the Government of India. To make up this deficit of the Supreme Government, the Provincial Governments should make to it fixed annual contributions, which should be determined after a careful consideration of the average liability of each province to famine as also of the need of making increased grants to local bodies out of provincial resources.' Cmd. 4360 (1908), p. 58.

Governments or *vice versa.*[1] A clear-cut division of functions and resources between various tax jurisdictions is only thinkable in a new island recently inhabited in which primitive conditions prevail. But even there after some time mutual adjustment of functions and resources among the competing tax authorities would necessitate transfers of funds from one tax authority to another, as the financial history of several federations has proved.

Starting with the principle that the system of contributions is an acknowledged method of transferring funds from one tax jurisdiction to another, let us examine the various methods which the Committee could have adopted for calculating the contributions. These can be arranged as follows:

(i) *Contributions in Proportion to Expenditure*: This recognizes thrift and penalizes extravagance. But as the expenses of Provincial Governments vary largely from province to province due to differences in cost of administration and responsibility, such a method, taken by itself, would create inequalities of burdens. Bombay, for example, on account of its high cost of administration, would be penalized under the scheme. Moreover, it may lower the efficiency of administration by cutting down necessary expenditure in the race for false economy between various provinces. The relative positions of the various Provinces on the basis of a levy in proportion to expenditure based on the expenditure figures settled at the Simla Conference can be seen from the following table:

PROVINCES	NORMAL EXPENDITURE SETTED AT THE SIMLA CONFERENCE	ORDER IN POINT OF EXPENDITURE	CONTRIBUTIONS FIXED BY THE COMMITTEE	ORDER IN POINT OF THE CONTRIBUTIONS
	Rs. LAKHS		Rs. LAKHS	
Madras ...	10,55	2	3,48	1
Bombay ...	10,99	1	56	6
Bengal ...	7,92	4	63	5
United Provinces ...	8,63	3	2,40	2
Punjab ...	7,33	5	1,75	3
Burma ...	7,21	6	64	4
Bihar and Orissa ...	4,18	7	nil	..
Central Provinces ..	4,14	8	22	7
Assam ...	1,63	9	15	8

[1] Seligman: *Essays in Taxation,* 10th edition, pp. 663-9. See ch. i for a discussion of the question.

(ii) *Contributions Based on Population* : This provides a rough and ready method of assessing a levy, but it would not result in an equitable distribution of burdens. Population alone in a large country like India with its different parts unequally economically developed is a bad index for the measurement of the paying capacity of a province. Such a levy would demand from the thickly populated Province of Bihar and Orissa a far higher amount than from Bombay with its vast industrial concerns. The relative paying position of the nine provinces on the basis of population can be seen from the following table.

PROVINCES		POPULATION (IN MILLIONS)	ORDER IN POINT OF POPULATION	CONTRIBUTIONS FIXED BY THE COMMITTEE Rs. LAKHS	ORDER IN POINT OF THE CONTRIBUTIONS
				Rs. LAKHS	
Madras	...	42.5	3	3,48	1
Bombay	...	19.3	6	56	6
Bengal	...	46.7	1	63	5
United Provinces	...	45.4	2	2,40	2
Punjab	...	20.7	5	1,75	3
Burma	...	13.2	8	64	4
Bihar and Orissa	...	34.0	4	nil	..
Central Provinces	...	13.9	7	22	7
Assam	...	7.6	9	15	8

(ii) *Contributions Proportionate to Revenue* : This also is not a fair basis because the sources of revenue which are left to the provinces bring different amounts of income. Land Revenue is a very important source of revenue to the Punjab and the United Provinces, while owing to the Permanent Settlement it is a relatively small and a highly inelastic source of revenue in Bengal and Bihar and Orissa. A levy proportionate to revenue would result in increasing the taxation of those who are already most heavily taxed. The comparative position of the Provinces on the basis of a levy proportionate to revenue based on the Simla Conference figures as compared with the contributions fixed by the Committee are shown in the following table:

PROVINCES	NORMAL REVENUE SETTLED AT THE SIMLA CONFERENCE	ORDER IN POINT OF REVENUE	CONTRIBUTIONS FIXED BY THE COMMITTEE	ORDER IN POINT OF THE CONTRIBUTIONS
	Rs. LAKHS		Rs. LAKHS	
Madras ...	14,42	1	3,48	1
Bombay ...	11,48	3	56	6
Bengal ...	7,73	6	63	5
United Provinces	12,07	2	2,40	2
Punjab ...	9,62	4	1,75	3
Burma ...	8,12	5	64	4
Bihar and Orissa	4,15	8	nil	..
Central Provinces	4.21	7	22	7
Assam ...	1,79	9	15	8

From the above table it is clear that if contributions based on revenue had been accepted the position of Bombay would have been seriously affected. Bombay's position was sixth in the Meston Settlement while it would have occupied the third place on the basis of a levy proportionate to revenue. The position of the United Provinces and Madras would not have been affected.

(iv) *A Levy Proportionate to Surpluses*: This method was actually adopted by the authors of the Reforms. As noted in chapter III this method was highly unfair—as it penalized thrift and encouraged extravagance. It takes into consideration the highest scale of expenditure and the lowest scale of revenue. The Meston Committee rightly abandoned it and adopted a new basis for its levy. The relative position of the various provinces on the basis of the Montford Reforms and the Meston Settlement are placed side by side in the following table:

PROVINCES	CONTRIBUTIONS PROPOSED BY THE AUTHORS OF THE REPORT	ORDER IN POINT OF CONTRIBUTIONS PROPOSED BY THE REPORT	CONTRIBUTIONS FIXED BY THE MESTON COMMITTEE	ORDER IN POINT OF CONTRIBUTIONS FIXED BY THE COMMITTEE
	Rs. LAKHS		Rs. LAKHS	
Madras ...	4,28	1	3,48	1
Bombay ...	88	5	56	6
Bengal ...	69	6	63	5
United Provinces	3,27	2	2,40	2
Punjab ...	2,18	3	1,75	3
Burma ...	1,40	4	64	4
Bihar and Orissa	39	7	nil	..
Central Provinces	36	8	22	7
Assam ...	13	9	15	8

The above table is instructive in pointing out that the relative position of Madras and the United Provinces in the scale of contributions was the same under both the Montagu-Chelmsford Reforms and the Meston Settlement. While Bombay was fifth under the Reforms scheme, it was sixth under the Meston Settlement.

(v) *Lastly, Contributions on the Basis of the Increased Spending Power, under the new allocation of resources:* This system was adopted by the Meston Committee. But the Committee tempered this principle in the light of the actual economic circumstances of each province. Thus the backward Province of Bihar and Orissa was entirely exempted from the payment of the initial contributions. Burma, Assàm and the Central Provinces were also given special treatment. Bombay, Bengal, the United Provinces, the Punjab and Madras were treated equally.[1]

The so-called Injustice of the Meston Settlement Examined

This new allocation of resources was universally condemned by all the Provinces[2]. The contributions fixed by the Committee were thought to be highly unfair and inequitable. Each province had its own grievance and it made the most of it. Bengal pointed out that her financial difficulties were peculiar and greater than those of the other Provinces on account of the Permanent Settlement. The Joint Select Committee had also recommended that Bengal should receive special consideration from the Government of India. Further, Bengal (and Bombay also) vehemently protested that under an equitable settlement the true test of what Bengal (or any other province) was paying to the Central Government was not its contribution under the Meston Settlement, but what the Central Government actually received from it in the shape of direct or indirect contributions. Bengal argued (and this equally applied to Bombay) that on account of her wealth, population, trade and industries, the monopoly of jute trade and the port of Calcutta, her contribution to the Central Government in the shape of income-tax, super-tax and customs (apart from other items) far exceeded that of most

[1] See ch. iii.

[2] For the views of the Provincial Governments on the Meston Committee Report see Cmd. 974 (1920).

other provinces.[1] Madras felt that she was the milch-cow and was proportionately contributing a larger share towards the Imperial deficit than any other province. The United Provinces and the Punjab had the grievance that they were hard hit on account of the heavy contributions and the remaining revenues did not leave enough surplus to develop their potential industrial activities. Bombay lodged a protest that as an industrial province with a high cost of administration she had been most unfairly treated in the matter of income-tax, which she regarded as her best source of income. Bihar, even though she was contributing nothing, protested that as a backward province she required a large capital expenditure to bring her into line with the advanced industrial Province of Bengal which had so far ignored her development and requirements. The Central Provinces made further claims upon the Central Government on account of their backward condition. Assam loudly protested that unless the arrangement was quickly changed her Government was 'pre-doomed to impotence and failure'. Lastly, Burma claimed larger revenues to develop her vast natural resources.[2]

In this sharp conflict of inter-provincial claims of interests, it was exceedingly difficult to achieve justice. Bearing in mind the past inequalities of treatment, and the differences of uneven economic development, let us examine the claims and counter-claims of the Provinces over the injustice of the Meston Settlement.

The fallacious arguments of Bengal and Bombay claiming special treatment were based on the so-called indirect contributions made by them to the central revenues. The Bengal Government in its reply of June 2, 1920, to the proposals of the Financial Relations Committee wrote: 'Under certain heads, e.g. railways and posts and telegraphs, this [*i.e.* the endeavour to ascertain indirect contributions] no doubt, would be difficult, if not impossible, but there are other sources, of which the important are income-tax (including super-tax) and customs (including salt), which bulk exceedingly largely in the figures and which have a vital bearing on the whole problem.'[3] Similarly,

[1] See ch. i. [2] Cmd. 974 (1920). [3] Ibid.

the Bombay Government, in its reply of June 3, 1920, to the Government of India's letter, pointed out that the only solution for the success of the Reforms was to allow her half the share in the income-tax, including super-tax, collected in the Presidency.

These claims are based on the assumption that each province has a natural right to the revenues collected within its boundaries. This view is particularly indefensible in India where the tax jurisdictations were artificially made with the haphazard growth of British power in India. Let us take the most obvious examples, *i.e.* customs and income-tax. The customs revenue, collected in India at the important ports of Calcutta, Bombay and Madras, is a tax paid by the consumers of imported goods living in the remotest corners of the country and not only by the people in the provinces where the ports happen to be situated. In fact, it is impossible to find out the exact amount contributed by each province unless we develop the most elaborate system of bonding to trace the ultimate destination of the imported goods.

Similarly, in the case of income-tax (as we have already pointed out) the place where the tax is collected is not necessarily the place where the tax is earned. Large public companies do business in more than one State in India. Profits in the case of ramifying enterprises are collected at the headquarters of the business, but it is impossible to calculate what percentage of the profits are earned within the State where the business has its headquarters. However, in the case of public companies the shareholders are scattered all over India elsewhere and the income-tax is collected at the head office of business. An allocation of income-tax receipts to the States on the basis of origin would result in vast inequalities of tax burdens.

But even if these difficulties could be overcome, it would be a travesty of justice to allocate such revenues to the States where the tax is collected, for, as the Simon Commission rightly observed, the population of towns, and in particular that of capital cities, builds up its economic life on that of the country as a whole, while the prosperity of the great ports has its root in the villages of the interior as well as in those of seaboard states themselves. The profits of the shipping concerns, insurance companies, com-

panies, commercial houses and the cotton or jute mills of Bombay and Calcutta are based on the prosperity of the country as a whole. It would be most unsound logic to attribute the revenues under these heads to Bengal or Bombay alone. On the contrary, the good fortune of the States is clearly dependent upon the general economic prosperity of the country as a whole, of which no doubt they are important parts.

Defects of the Meston System

The greatest defect of the Meston Settlement, however, lay in the fact that it created inequalities of tax burdens between the different classes of the community. It handicapped the industrial Provinces (as compared with the agricultural Provinces) in not giving them power to tax industrial activities. Thus a highly industrial province like Bombay was administered and financed out of the taxation of small cultivators (land revenue) and the labouring classes (excise). A detailed study of the provincial budgets elsewhere shows the huge divergence between the provinces in the extent of their dependence on various classes of revenue.[1] Bengal was largely financed out of the revenue from stamps arising mostly out of litigation. The prosperity of Madras, Bihar and Orissa depended largely upon the revenue derived from the sale of liquor licences. The poor cultivators of the United Provinces were made the scapegoats of the burdens and penalties of the costly administrative machinery. Thus the growth and development of education, hospitals and dispensaries, roads and industries, was financed in one province from the income from litigation, in another from the excessive consumption of the much hated liquor and in a third from the revenue derived from a highly indebted peasantry! A sad commentary on the distribution of burdens between the various sections of the community!

Again, it is significant to note that under the Meston Settlement, though the Provincial Governments provided law and order

[1] Cmd. 3569 (1930), par. 279.

and improved the conditions of living in the provinces, an average citizen in urban areas who did not consume 'country' liquor or involve himself in litigation did not contribute anything towards the provincial finances. Hence the great majority of the people in cities were mainly contributing to the central finances (e.g. in customs, salt tax or income-tax) though they were mainly benefited by the activities of the Provincial Governments. Division of income-tax or excise duties is the only practicable way to remove such a defect.[1]

The relative importance of the principal sources of revenue to the total revenue of the province is shown in Table V on the next page.

Conclusion

In conclusion it may be noted that the Meston Settlement has not been studied in a scientific impartial spirit. Over-zealous provincial patriotism has produced a coloured picture in which the real facts have been kept in the background. Those who condemn the Meston Settlement are out of court unless they can suggest a better alternative scheme *within the constitutional machinery* of the Reforms. It was not an ideal system and it never claimed to be. It was in harmony with the spirit of the Reforms. Change the character of the Reforms and the Meston Settlement is thrown overboard. The Meston Settlement has received more destructive than constructive criticism.

Above all, it must always be remembered that India as a whole is much bigger than any of the provinces. The vital interests of the whole country are much more important than the isolated problems of any of the provinces. If the credit of India had been seriously shaken in the economic blizzard that swept over the country between 1921–4, what would have become of the provinces?

Provincial autonomy would have ended in smoke. We must realize that we are citizens of India first and citizens of the Provinces or States next. Over-zealous provincial patriotism is bound to breed jealousies which are highly detrimental to the

[1] See ch. i.

TABLE V

RELATIVE IMPORTANCE OF THE PRINCIPAL HEADS OF REVENUE TO THE TOTAL REVENUE OF THE PROVINCE

PROVINCES	TOTAL PROVINCIAL REVENUE AVERAGE 1925-35	PERCENTAGE OF LAND REVENUE TO THE TOTAL REVENUE OF THE PROVINCE	ORDER IN POINT OF PERCENTAGE	IRRIGATION	ORDER	EXCISE	ORDER	STAMPS	ORDER	REGISTRATION	ORDER	FORESTS	ORDER
	Rs. 1,000												
Madras ..	16,81,57.8	34.9	5	10.2	2	29.3	1	13.7	4	2.1	2	3.1	6
Bombay ..	14,77,01.7	31.6	7	3.38	5	25.1	2	11.0	6	0.9	5	4.4	5
Bengal ..	10,32,74.9	28.3	8	—0.017	..	17.2	6	30.9	1	2.7	1	2.3	8
United Provinces ..	12,00,76.8	52.8	2	8.85	3	10.6	8	14.4	3	1.1	4	4.6	4
Burma ..	9,48,76.0	55.6	1	3.24	6	11.4	7	6.4	9	0.6	7	16.0	2
Central Provinces ..	4,89,32.9	46.1	3	0.15	7	20.1	5	12.6	5	1.2	3	17.5	1
Assam ..	2,50,75.3	45.8	4	..	..	22.6	3	8.1	8	0.8	6	9.9	3
Punjab ..	10,98,85.0	25.2	9	35.59	1	10.0	9	10.3	7	0.8	6	2.6	7
Bihar and Orissa ..	5,49,34.6	31.9	6	3.93	4	21.3	4	19.8	2	0.9	5	1.5	9

progress of the country. The true line of patriotism lies in a frank and free recognition of the greater needs of the country as a whole in subordination to the needs of the parts. The sooner this maxim is realized the sooner the different parts of the country will march together towards the harmonious development of the whole country.

V

PROVINCIAL AUTONOMY

§ 1. *CONSTITUTIONAL BASIS*

Provincial Autonomy a Natural Development

'The Provinces are the domain', wrote the authors of the Montagu-Chelmsford Reforms, 'in which the earlier steps towards the progressive realization of responsible government should be taken. Some measure of responsibility should be given at once, and our aim is to give complete responsibility as soon as conditions permit.' The reforms of 1919 were a transitional stage in the introduction of provincial autonomy. The reforms had introduced a large measure of responsible government in the Provinces, but after working for more than a decade it was felt that a stage had been reached when the limits imposed by the Act of 1919 should be considerably extended. The lines of the future reforms were examined by the Statutory Commission (1930). The principles of the constitutional settlement recommended by the Statutory Commission, however, were not favourably received in India. Meanwhile, Indian political opinion became keenly conscious of the imperfections of the Indian polity so long as there was no constitutional relationship between the Indian States and British India. The three Indian Round Table Conferences and the Joint Committee on Indian Constitutional Reforms (1933-34) resulted in the passing of the Government of India Act, 1935. This Act established provincial autonomy in the Provinces (1937) and proposed to create an All-India Federation by means of which the Indian States and Provinces should decide policies affecting India as a whole.

Distribution of Legislative Powers

The Act of 1935 recognized three classes of subjects: (i) exclusively federal, (ii) exclusively provincial and (iii) con-

current.[1] This means that functions like defence, foreign relations, navy and air force, railways, currency and coinage and public debt have been reserved for the federal authority. *Secondly*, education, medical, public health, police, law and order have been reserved for the Provincial Governments. Finally, there is a class of functions (e.g., employers' liability and workmen's compensation, trade unions and welfare of labour) in which the Central Legislature has concurrent powers of legislation with the Provincial Legislatures, with provision for resolving a possible conflict of laws. In all federations it has been found necessary to provide the Central Legislature with legislative jurisdiction throughout the country to secure uniformity in the main principles of law, and to permit the Provincial Legislatures to vary the laws to meet the particular circumstances of a province. The Concurrent legislative list provides for such cases.

As a result of this division of functions the Provinces possessed an exclusive authority to legislate on the provincial subjects. This authority was broadly free from the Central Government and Legislature. In the Concurrent field of legislation the Provinces could vary the laws to suit local conditions.

Essence of Provincial Autonomy

The essence of provincial autonomy, as understood by the Joint Committee on Indian Constitutional Reforms (1933-34), consisted in each of the Governor's Provinces possessing an executive and a legislature having exclusive authority in a precisely defined sphere, within which it was broadly free from control by the Central Government and Legislature. This represented a fundamental departure from the reforms of 1919, under which the Provincial Government exercised a *devolved* and not an *original* authority. Under provincial autonomy the Central Government and Legislature ceased to possess in the Governor's Provinces any legal power or authority with respect to any matter falling

[1] The subjects in List I, *i.e.* the exclusively provincial list, represent generally, with certain additions, those which the Devolution Rules under the Act of 1919 earmarked as 'Provincial Subjects'.

The dyarchic system in the Provinces by which the subjects were divided as 'Reserved' and 'Transferred' was abolished.

within the exclusively provincial list of subjects, except that of supervision under certain conditions. The provincial executive, with the Governor as its head, was entirely responsible for provincial administration and maintenance of law and order.

Main Features of Provincial Autonomy

There are thus three main features of provincial autonomy. In the first place it abolished the dyarchic system introduced by the reforms of 1919. The division of provincial subjects into 'reserved' and 'transferred' was abolished, and the provincial ministers were generally responsible over the whole field of provincial government.

Secondly, the provincial executive were responsible for the fundamental functions of government: the enforcement of law and order, and the maintenance of an upright administration. This responsibility raised a wider question, namely, the relationship of the provincial ministers with the Governor as the head of the provincial executive. Responsible parliamentary government, as rightly observed by the Joint Select Committee, works by the interaction of four essential factors: the principle of majority rule; the willingness of the minority for the time being to accept the decisions of the majority; the existence of great political parties divided by broad issues of policy, rather than by sectional interests; and the existence of a mobile body of public opinion, owing no permanent allegiance to any party and therefore able to keep the vessel on an even keel. In India some of these factors, as they are understood in the United Kingdom did not exist. Hence it became essential to introduce some safeguards; that is, to give certain special responsibilities to the Governors. The safeguards, it was understood, were not to be used by the Governors in the daily

[1] The Governors were given power to take executive action (i) to prevent any grave menace to the peace or tranquillity of the Province, or any part thereof; (ii) safeguard the legitimate interests of minorities; (iii) to secure to the members of the Public Services any rights provided for them by the Constitution and to safeguard their legitimate interests; (iv) to administer certain areas declared in accordance with special provisions, to be 'partially excluded' areas; (v) to secure the execution of orders lawfully issued by the Governor-General.

The Governor of Sind had a special responsibility for the administration of the Sukkur Barrage and Canals Scheme.

administration of the Government. They were vested in him to hold the scales evenly between conflicting interests and to protect those who had neither the influence nor the ability to protect themselves.

Lastly, provincial autonomy meant greater responsibility in the sphere of social administration. The Government of India always followed a policy of neutrality and non-interference in all social and religious matters in India. This policy of non-interference, however justifiable it may have been in the past, needed a revision to carry into effect social legislation in such matters (to name only two obvious instances) as child-marriage and the problem of untouchables. Such reforms could only be carried out under responsible government. Provincial autonomy offered the widest scope for that social legislation on which the future progress of India depended.

Provincial autonomy thus established a substantial measure of responsible government in the provinces. It is, however, necessary to realize that Indian constitutional problems are different from the constitutional problems of other countries. The responsible Government of India must be different from that of England. For responsible government is not an automatic device which can be manufactured to specification. Hence provincial autonomy in India was moulded to suit social conditions and national aptitudes. It is from this point of view that some necessary safeguards were inserted in the Instrument of Instructions. These safeguards had not lowered the value of provincial autonomy but had strengthened the executive. Finally, it must be remembered that the success of a constitution depends far more upon the manner and spirit in which it is worked than upon its formal provisions.

§ 2. *THE CHANGES IN THE FINANCIAL SYSTEM*

Introductory

The problem of the allocation of resources between the Federation and the Units is necessarily one of difficulty. The

problem would be simplified if it were possible to allocate separate sources of revenue to the two authorities which would fit in with the economic and financial requirements of each party. This, however, is not a problem easy of solution. It has often been found that the yield from the sources of revenue assigned to the Units or the Centre is either deficient or in excess of their requirements, and hence a system of grants-in-aid or subventions is normally adopted to balance the budget.

In India the problem is not a new one. A system of doles from the Centre to the Provinces or contributions from the Provinces to the Centre, or a system of shared revenues, was often adopted between the two parties.[1] Together with this division of resources there always was a division of the functions to be performed by each party. Past experience has shown that the sources of revenue assigned to the Provinces were always inadequate for the full development of their social needs. Hence there had always been an attempt from provinces to demand a larger share of the resources of the Centre.

With the entry of the States into the Federation the question became one of formidable difficulty. The Butler Committee (1928-29) and the Davidson Committee (1932) tried to solve the problem. The demand of the Provinces that the States should share the burden of the income-tax and the corporation tax, and the claim of the States that they should share the proceeds of the Customs complicated the situation. The States' contributions to the Government of India and the rights of the maritime States in relation to sea customs presented problems of unusual difficulty.

In order to understand the allocation of sources of revenue between the Centre and the Units it is essential to study the subject in two parts: first, the allocation of the sources of revenue between the Federation and the Units; and second, the financial position of the deficit provinces.

[1] See chs. ii, iii and iv.

[2] For the literature on the subject see:

(1) Report of Indian States Committee (*i.e.* Butler Committee), 1928-29.

Allocation of Sources of Revenue between the Federation and the Federal Units

The Meston Scheme, from the practical financial point of view, by allocating separate fields of taxation to the Government of India and the Provinces aimed to introduce a federal system of finance. The working of the system led to three conclusions: (i) that the provinces rarely had incomes adequate for a full development of their social needs; (ii) that the division of the heads of revenue between the Centre and the Provinces left the Centre with elastic heads of revenue; (iii) that the system of reserving taxes on income for the Centre handicapped the more industrialized Provinces like Bombay and Bengal.[1] An attempt was made in the Government of India Act 1935 to remove these defects. Under this Act the sources of revenue due to the Federation and the Federal Units were allocated thus :

1. PROVINCIAL

(A) Taxes Levied and Collected by Provinces

1. Land revenue.
2. Irrigation.
3. Duties of excise on the following goods manufactured or produced in the province and countervailing duties at the same or lower rates on similar goods manufactured or produced elsewhere in India:—

(*a*) alcoholic liquors for human consumption;

Continued from p. 93

(2) Report of the First Federal Finance Sub-Committee (*i.e.* Peel Committee, October 9, 1931) (Indian Round Table Conference, second session).
(3) Report of the Federal Finance Committee (*i.e.* Percy Committee, 1932, Cmd. 4069).
(4) Report of the Federal Finance Committee (Second Peel Committee, 1932-3, Cmd. 4238).
(5) Report of the Indian States Enquiry Committee (Financial) 1932 (Davidson Committee).
(6) White Paper (December, 1931).
(7) Report of the Joint Committee on Indian Constitutional Reforms, 1933-4.
(8) The Government of India Act, 1935.
(9) Indian Financial Enquiry Report (Sir Otto Niemeyer's Report, 1936, Cmd. 5181).

[1] See ch. iv.

(*b*) opium, Indian hemp, and other narcotic drugs and narcotics, non-narcotic drugs;

(*c*) medicinal and toilet preparations containing alcohol or any substance included in sub-paragraph (*b*) of this entry.

4. Taxes on agricultural income.

5. Taxes on lands and buildings, hearths and windows.

6. Duties in respect of succession to agricultural land.

7. Taxes on mineral rights, subject to any limitations imposed by any Act of the Federal Legislature relating to mineral development.

8. Capitation taxes.

9. Taxes on professions, trades, callings and employments, subject, however, to the provisions of section 124A (1) of the Government of India Act.

10. Taxes on animals and boats.

11. Taxes on the sale of goods and on advertisements.

12. Cesses on the entry of goods into a local area for consumption, use or sale therein.

13. Taxes on luxuries, including taxes on entertainments, amusements, betting and gambling.

14. Stamps and registration.

15. Dues on passengers and goods carried on inland waterways.

16. Tolls.

17. Fees in respect of any of the matters in the Provincial Legislative List, but not including fees taken in any court.

(*B*) *Taxes Levied and Collected by the Federation but Assigned to the Provinces*

1. Duties in respect of succession to property other than agricultural land.

2. The rates of stamp duty in respect of bills of exchange, cheques, promissory notes, bills of lading, letters of credit, policies of insurance, proxies and receipts (as mentioned in Federal Legislative List I, item 57).

3. Terminal taxes on goods or passengers carried by railway or air.

4. Taxes on railway fares and freights

(*C*) *Taxes Divided between the Federation and the Provinces and the Federated States*

1. Taxes on income other than agricultural income.

2. Salt duties.

3. Duties of excise on tobacco and other goods manufactured or produced in India except

(*a*) alcoholic liquors for human consumption;

(*b*) opium, Indian hemp and other narcotic drugs and narcotics, non-narcotic drugs;

(*c*) medicinal and toilet preparations containing alcohol, or any substance included in sub-paragraph (*b*) of this entry.

4. Export duties (with special provisions for the jute export duty, Section 140 (2), Government of India Act).

II. FEDERAL

(*A*) *Taxes Levied and Retained by the Federation*

1. Corporation tax.

2. Currency and coinage.

3. Federal railways.

4. Post and telegraph including telephones, wireless, broadcasting, and other like forms of communication.

5. Import and export duties (with exceptions mentioned above).

6. Military receipts.

(*B*) Besides, the Federal Authority may also retain in part or whole the revenues from any of the sources mentioned in (*C*) above.

Distribution of Income-tax and Corporation Tax

It will appear from the above allocation of resources between the Federation and the Units that the most important changes in the allocation in comparison with the Meston Scheme were with reference to (i) income-tax, (ii) corporation tax and (iii) excise and export duties.

The first Peel Committee (1931) recommended that income-tax should be Provincial and corporation tax Federal. Income-tax was, however, in the interest of efficiency and uniformity of rates, to be collected by the Federal Government, and the net proceeds were to be redistributed to the Provinces. The redistribution of the proceeds among the provinces was a convenient way of alleviating the burden of some of the provinces which are poorer than others. The actual process of distribution was left to the Percy Committee.[1]

The Percy Committee (1932), after a careful examination of the future finances of the Federal Government, came to the conclusion that the transference of the entire income-tax to the Provinces would cause a huge permanent deficit in the Central finances. They therefore recommended that income-tax should be retained by the Federal Government, and a percentage of it should be transferred to each province. In addition, the Federal Government should also retain: (i) the tax paid by residents in the Federally Administered Areas and (ii) the tax paid on the salaries of federal officers. The corporation tax was to remain a federal source of revenue. The Committee recommended that the provincial contributions should be extinguished by annual stages over a definite period, such as ten or fifteen years.

As regards the principles of distribution of income-tax receipts, the Committee considered allocation on the basis of *collection, population, origin* and *residence*. Each of these methods was open to objection. Allocation on the basis of *collection* would have led to gross injustice as between province and province. Companies, operating over large areas, are assessed at their head office, which is often situated in an industrially more advanced province. Moreover, interest on securities held all over the country is paid at the Public Debt offices in Calcutta, Bombay and Madras. Thus the mere accident that the income is assessed at a certain place is no reason why the benefit should go to that particular province. This basis was, therefore, ruled out.

[1] Cmd. 4069 (1932).

Distribution by *population* has no scientific basis because industrially-advanced rich provinces may have a small population. Yet population can be adopted with advantage for the distribution of taxes on certain forms of income which cannot easily be assigned to any particular locality, such as the undistributed profits of Companies and the income of non-residents.

Allocation on the basis of *origin* is theoretically sound, but administratively it is not workable in respect of the income of individuals and even in respect of the income of Companies it would be workable only if the allocation were to be made wholly on arbitrary lines 'either by investing income-tax officers with unlimited discretion, or by laying down uniform rules of allocation, irrespective of widely varying conditions'. This method, hence, was also not adopted.

The Committee adopted *residence* (*i.e.* the tax actually paid by the residents of a province) as the basis of the allocation. Each province was credited with the tax paid by persons resident in it (*i.e.* by individuals, Hindu undivided families, unregistered firms and certain associations), including tax on dividends received by them from Companies. In allocating ordinary income-tax on this basis there were, however, practical difficulties. As a substantial part of the ordinary income-tax is collected at the source and no formal assessment is made, on the assumption that the taxpayer has no other source of income, it was difficult to ascertain the amount of tax which should be credited to each province. The Committee recommended that the records should be modified in such a way as to facilitate the ascertainment of the personal income-tax which should be credited to each province. Meanwhile, they thought the only practicable course was to throw all the personal income-tax (*i.e.* excluding personal super-tax) into a common pool and to distribute this pool between the Provinces on the estimated basis of the probable amount of tax paid by the residents on their incomes. As regards personal super-tax which is, generally speaking, collected after formal assessment, there could be no difficulty. It was to be credited to the Province where the assessment was made.

The proceeds from the assessment of the income of non-residents and undistributed profits of Companies were to be dis-

tributed on the basis of population. This would have helped, to some extent, the poorer provinces with large populations such as Bihar, Orissa and the United Provinces.

The Distribution Proposed

On the basis of the above recommendations the proceeds were to be distributed in the following manner :

	(lakhs of rupees)
Total Gross Yield of Income-tax	18,00
Less Cost of Collection	80
Net yield ..	17,20
Super-tax on Companies, Tax on Salaries of Federal Officers and Personal Income-tax and Super-tax levied in Federal Areas (to be Retained by the Federal Government)	3,70
Balance Available for Distribution to the Provinces ..	13,50

Out of the total, about Rs. 2,00 lakhs represented personal super-tax (*i.e.* other than Company super-tax) and was to be distributed on the basis of actual collections from residents. Of the balance of Rs. 11,50 lakhs, about one-seventh was approximately estimated to be the tax on the undistributed profits of Companies and on the incomes of non-resident persons. This amount (*i.e.* one-seventh of Rs. 11.50 lakhs) was to be distributed on the basis of population. The remaining six-sevenths was to be distributed on the basis of the estimated share of personal income-tax creditable to each province. The result of the distribution on the above basis is shown in Table VI on page 100.

Though the above settlement of the Percy Committee was not adopted under the Act 1935, yet it opened a new field of inquiry. The Committee must be given the credit for realizing the difficulties of the deficit provinces. Their analysis of the division of income-tax in various parts was of immense help in Sir Otto Niemeyer's settlement. Finally, the Committee came to the conclusion that perfect equality of treatment was an impossibility in any federation, let alone in India. The Committee's words may with profit be quoted here: 'It is doubtful whether a jealous comparison of relative burdens offers a sound basis for a successful partnership. Each partner in a

TABLE VI

DISTRIBUTION OF INCOME-TAX

IN LAKHS OF RUPEES

PROVINCES	TWO CRORES ON COLLECTIONS OF PERSONAL SUPER-TAX	ONE-SEVENTH OF 11½ CRORES ON POPULATION BASIS	SIX-SEVENTHS OF 11½ CRORES ON BASIS OF PERSONAL INCOME-TAX WITHOUT FEDERAL SALARIES	TOTAL
Madras	7	30	1,46	1,38
Bombay[1]	50	14	2,79	3,43
Bengal	1,10	32	2,63	4,05
United Provinces	8	31	84	1,23
Punjab	2	15	74	91
Bihar and Orissa	18	24	65	1,07
Central Provinces	3	10	46	59
Assam	1	6	22	29
North-West Frontier Province[2] ...	1	2	7	10
Total ...	2,00	1,64	9,86	13.50

[1] Includes Sind. Figures for the latter in respect of Columns 2 and 4 are not readily available, but are roughly estimated at about one-sixteenth (under both the columns together) of the total figure for Bombay plus Sind.

[2] The share due to the North-West Frontier Province will presumably go in reduction of the subvention to that Province.

new enterprise must bring something substantial into the common pool and may expect to derive solid advantages from the partnership commensurate with his contribution; but, if these conditions are fulfilled, the partners will be unwise to insist on a meticulous equality. They will probably find it best to take their associates as they are. Similarly, a new federation may find, at the commencement of its existence, that the conception of maintaining the *status quo* in non-essentials is a better guide to policy than any ambitious ideals of equality or uniformity.' (Par. 93.)

The Report of the Second Peel Committee[1]

The Second Peel Committee (1932), following the lines of the Percy Report, envisaged a twofold division of taxes on income into shares which would be permanently assigned to the Federal Government and the provinces. To the Federal Government was assigned the proceeds of the tax derived from: (i) corporation tax, (ii) tax on federal officers, (iii) tax in federal areas, (iv) tax on Government securities and (v) tax on the incomes of persons not resident in British India.[2] The whole of the remaining proceeds from taxes on income was to be assigned to the Provinces. The proposals in paragraphs 74 and 75 of the Percy Report (mentioned above) were regarded by the Committee as suitable for the actual distribution of the proceeds.

At the outset of the Federation, however, in order to ensure the solvency of the Central Government, it was proposed that out of the provincial share of taxes on income the Federal Government should retain a block amount for a period of x years. The amount would be deducted by the Federal Government from the total yield before any distribution took place.

The initial amount fixed for the period of x years, it was recommended, should gradually be reduced to zero. Hence the duration of the period was divided into two parts, during the

[1] The Report is contained in Indian Round Table Conference (Third Session) November 17 to December 24, 1932, Cmd. 4238 (1933).

[2] The Committee thought, on the estimate of the Percy Report, that the yield from the five heads quoted above would be 5¼ crores out of the total yield of 17¼ crores. The representatives of British India said that the Federal Government should retain only 5 crores while the States' representatives agreed to assume the burden of corporation tax if the Federal Government retained 8¼ crores (par. 4).

second half of which the entire amount was to be finally allocated to the provinces. Regarding the duration of the x period the Committee were unable to report agreement on account of the differences between the British Indian and the States' representatives—the former insisting on a minimum period of ten years divided into two parts of at least five years each, the latter insisting on limiting the x period to four or five years.

The States' representatives agreed to assume liability for corporation tax on the expiration of the period of x years, subject to the understanding that, assessment of the tax on the Companies in a state having been made, the State might raise the amount due to the Federation by any method it chose, and not necessarily by the actual levy of that tax.[1]

In addition to the above division of taxes on income it was recommended that, so far as British India was concerned, the Federal Government should have power to levy, for its own purposes, an additional tax on the heads of income-tax permanently assigned to the provinces. Similarly, each province individually was to have a right of surtax upon the personal tax levied on inhabitants under the heads permanently allocated to the provinces, subject to a maximum of 12½ per cent of the tax centrally imposed. This surtax, like all other taxes on income, was to be collected by a federal agency.

White Paper Proposals[2]

The White Paper proposed the following solutions :

(i) Taxes on income derived from federal sources were to be permanently assigned to the Federation.

(ii) Of the yield of the rest of the normal taxes on income (except the corporation tax), not less than 50 and not more than 75 per cent was to be assigned (by Order in Council) to the provinces.

(iii) Out of the amount assigned to the provinces the Federal Government (during a transitional period) was to retain an amount which was to remain constant for three years and was thereafter to be reduced gradually to zero over a further period of

[1] Report par. 8. [2] December 1931.

seven years—the Governor-General being given power to suspend these reductions, if circumstances made it necessary to do so.

(iv) The Federal Government was to be empowered to impose a surcharge on taxes on income, the proceeds of which were to be devoted solely to federal purposes.

(v) The corporation tax was to be retained by the Federation, and after ten years, the tax should be extended to the States. The States, however, were given the right not to subject Companies to the tax and to pay themselves to the Federation an equivalent lump sum contribution.[1]

(vi) The Provincial Legislatures were empowered to impose a surcharge not exceeding 12½ per cent on the taxes levied on the personal income of persons resident in the province, and to retain the proceeds for their own purpose.[2]

(vii) The provinces were empowered to impose taxes on agricultural incomes, which are not at present subject to income-tax.

Joint Committee Report[3]

The Joint Committee suggested that the share assigned to the provinces should not be more than 50 per cent. The determination of the actual period (3 and 7 years suggested by the White Paper) during which the Centre should retain a part of the portion assigned to the provinces was left to be decided by an Order in Council.

The provincial surcharges of 12½ per cent on the taxes levied on the personal income of persons resident in the province were not favoured by the Committee.

Sir Otto Niemeyer's Report

Sir Otto Niemeyer was appointed to make recommendations after reviewing the budgetary positions of the Government of India and the provinces, on matters under sections 138 (1) and (2)—the allocation of taxes on income other than taxes on agricultural income; 140 (2)—the assignment of the net proceeds of the jute export duty; and 142—grants-in-aid to the revenues of the Provinces—of the Government of India Act 1935.

[1] par. 142. [2] par. 57. [3] H.C. 5, I Part, 1934.

Sir Otto's aim throughout his recommendations was two-fold. He always kept in mind the stability of the central finances. Besides, his aim was that at the inauguration of provincial autonomy each of the provinces should be so equipped as to enjoy a reasonable prospect of maintaining financial equilibrium. A real attempt was made to remove the chronic state of deficit of some of the Provinces.

Regarding the distribution of income-tax[1] under section 138 of the Government of India Act, Sir Otto Niemeyer made the following recommendations:

(i) (*a*) That the percentage prescribed under Section 138 (1) should be 50 per cent.

(*b*) That the percentage distribution of this share to be prescribed under the same sub-section should be:

Madras	15
Bombay	20
Bengal	20
United Provinces	15
Punjab	8
Bihar	10
Central Provinces	5
Assam	2
North-West Frontier Province ..	1
Orissa	2
Sind	2

(ii) That the amount to be retained under section 138 (2) from this share should be:

For a first period of five years, in each year, the whole or such amount as, together with any general budget receipts from the railways, will bring the Central Government's share in the divisible total up to 13 crores, whichever is less; and

For a second period of five years, in the first year, five-sixths of the sum, if any, retained in the last year of the

[1] Out of the total income-tax receipts the following deductions must be made to find out the amount available for distribution among the Provinces:

(i) Corporation tax.
(ii) Receipts from the Chief Commissioners' Provinces.
(iii) Receipts from Federal emoluments.
(iv) Cost of collection.

Of the residium 50 per cent is allocated for provincial distribution.

first period, decreasing by a further sixth of that sum in each of the succeeding five years.

The most difficult question was the manner in which the proceeds of taxes on income were to be distributed among the provinces. On this contentious question, on many occasions in the past, each province had advocated the basis of division (collection, population, origin, residence) which would have given it the largest dividend. We have already remarked that no basis possesses any scientific validity or satisfies in any appreciable degree the test of the paying capacity of a province. And, even if we could find out exactly to what part of India particular fractions of income belong and therefore where the incidence of the taxation burden rests, 'it is still arguable that in a federation other considerations also are involved; particularly if the benefits and incidence of other forms of common taxation are unequally divided as between the various partners.'[1]

After taking into consideration the various aspects of the problem, Sir Otto fixed the percentages mentioned above, partly on residence and partly on population, paying to neither factor a rigidly pedantic deference.[2] This, perhaps, has been the best proposal for the allocation of income-tax, as between the Provinces *inter se,* since the Montagu-Chelmsford Reforms of 1919.

Corporation tax is a federal source of revenue. It was not to be levied by the Federation in any federated state until ten years had elapsed from the establishment of the Federation. The Ruler of any Federal State was, however, authorized to pay the tax himself to the Federation. The tax in such a case was not to be levied in the State. When the Ruler of a State so elected to pay the tax the officers of the Federation were not to call for any information or returns from any corporation in the State, but it was to be the duty of the Ruler to supply to the Auditor-General of India such information as he may reasonably require to enable him to determine the amount of any such contribution. If the Ruler of the State was dissatisfied with the determination as to the amount of the contribution payable by his State in any

[1] par. 30. [2] par. 34.

financial year, he could appeal to the Federal Court, and if he established to the satisfaction of that Court that the amount determined was excessive, the Court was to reduce the amount accordingly and no appeal was to lie from the decision of the Court on the appeal.

Deficit Provinces

We now come to the question of deficit provinces. Sir Otto after reviewing the budgetary position of the provinces came to the conclusion that Sind, Orissa, Assam and the North-West Frontier Province could not balance their budgets and urgently needed additional resources.

Sind. In 1936-7 the Government of India provided a subvention to Sind of Rs. 102 lakhs plus non-recurrent grants of Rs. 4 lakhs for initial equipment and election costs and Rs. 2 lakhs unallocated. In addition Rs. 17½ lakhs were provided for buildings in Karachi.

The future finances of Sind were bound up with the financial future of the Lloyd Barrage. After a survey of the prospects of the Barrage scheme Sir Otto recommended that Sind should receive a subvention of 105 lakhs for a period of 10 years (*i.e.* till 1946–7 inclusive); that then it should be diminished by 25 lakhs a year for 20 years; by 40 lakhs a year for the next five years; by 45 lakhs a year for the next succeeding five years and thereafter until the whole Barrage debt had been repaid the subvention should be at a rate of 50 lakhs a year. When the debt has been repaid (*i.e.* in about 40 years from funding in 1942) any remaining portion of the subvention will, of course, in any event cease.[1] Besides this, a single non-recurrent grant of 5 lakhs, towards the cost of a jail at Shikarpur, was also recommended.

Orissa. In 1936-7 the Government of India assisted Orissa by a grant of 50 lakhs of which 40½ lakhs was in respect of the deficit in the budget; 7½ lakhs (non-recurrent) was given for the establishment of famine and road funds and initial equipment, and 2 lakhs was an unallocated grant.

[1] par. 13.

Sir Otto recommended that the recurring grant of Orissa should be fixed at 50 lakhs. In addition a non-recurring grant of 19 lakhs should be given.[1]

Assam. The recurring grant of Assam was fixed at 45 lakhs a year. In addition 7 lakhs per year was provided towards the cost of the Assam Rifles. In view of this grant the claim of Assam for the proceeds of the excise duty on Assam oil did not require further consideration.

The North-West Frontier Province. The Province had received an annual subvention of one crore from the Government of India since 1932. This subvention under section 142 of the Government of India Act could be increased at any time without an address from the Federal Legislature.

The future subvention of the Province was fixed at 110 lakhs and it was recommended that the subsidy should be subject to revision after five years.

Subventions to Other Provinces. Apart from the specific cases of the deficit provinces, some assistance was also recommended to other provinces.[*] This assistance was irrespective of the allocation of income-tax and was not affected by it. Below the whole provision is summarized:

Bengal	75 lakhs
Bihar	25 lakhs
Central Provinces	15 lakhs
Assam	45 lakhs (plus 7 lakhs in respect of the Assam Rifles, par. 15)
North-West Frontier Province	110 lakhs
Orissa	50 lakhs (plus 19 lakhs non-recurrent, and to diminish as indicated in par. 13 of the Report)
Sind	105 lakhs (plus 5 lakhs non-recurrent, and to diminish as indicated in par. 13 of the Report)
United Provinces	25 lakhs for 5 years
Total ..	450 lakhs

[1] par. 14.

Decentralization of Balances and Debt Cancellation

A part of the above subventions recommended to the provinces, Sir Otto suggested, could be conveniently provided by decentralization of balances and debt cancellation. On financial and administrative grounds the proposal was also extremely desirable. In so far as the provinces would be using surplus balances as a set-off to debts due by them to the Centre, it was suggested that such reduction of their debts should be taken as part of the assistance proposed above. But because, as a result of this proposal, the provinces had to bear certain interest charges which had hitherto fallen on the Centre, allowance was made for such charges before the actual assistance was counted.

In the case of Bengal, Bihar, Assam, the North-West Frontier Province and Orissa, it was convenient to combine the results of decentralization of balances and of debt cancellation. Accordingly in the case of these provinces the entire existing debts were taken over by the Government of India. The resulting net annual budget saving to the provinces was counted against the assistance proposed to them. In the case of the Central Provinces a part of the debt was cancelled.

The following table shows the debt cancellations and the approximate net annual saving to each province:

Bengal	All debt contracted with the Centre prior to April 1, 1936	33 lakhs
Bihar		22
Assam		15½
North-West Frontier Province		12
Orissa		9½
Central Provinces	.. Deficit debt as on March 31, 1936 and approximately two crores of pre-Reform debt	15

Export Duty on Jute

Since 1921 Bengal had repeatedly pointed out the injustice of the Meston Award. In September 1921 Lord (then Sir) Malcom Hailey remitted Bengal's contribution of 63 lakhs to the Government of India. In the earlier discussions of the Round Table Conference the delegates from Bengal put forward a claim to a share of the proceeds from taxation of the export

of jute. The Percy Committee (1932) did not favour the claim as it would raise highly controversial questions of principle and would result in delaying *pro tanto* the remission of provincial contributions.

In chapter I we have pointed out the desirability of utilizing excise and export duties as balancing factors to correct inter-provincial inequalities and to introduce an element of greater elasticity in provincial revenues. It was on this principle that the White Paper[1] recommended that the Federal Legislature be empowered to assign to the Provinces and the States, in accordance with such schemes of distribution as it might determine the whole or any part of the net revenue derived from some federal excises, and export duties. In the case, however, of export duties on jute or jute products, an assignment to the producing units was compulsory, and was to amount to at least 50 per cent of the net revenue derived from the duty.

Under the Government of India Act[2] not less than half of the net proceeds of the export duty on jute in each year was to be assigned to the provinces or federated states in which jute was grown in proportion to the respective amount of jute grown therein. Sir Otto Niemeyer recommended that the percentage under section 140 (2) of the Act should be increased to 62½ on the estimated gross yield of the duty in 1936–37. This resulted in the following additions to the resources of the provinces :

Bengal	.. .. ..	42 lakhs
Bihar	.. .. ..	2½
Assam	.. .. ..	2½
Orissa	.. rather over	½

The Federal Legislature was also empowered under the Government of India Act to assign to the provinces the whole or any part of the net revenue derived from salt or other federal excises. This was a very important provision in the Act which could be utilized to fill the gaps and inequalities in the finances in the provinces resulting from artificial provincial boundaries or other considerations.

[1] December, 1931. [2] Section 140 (1).

The result of the help to the provinces due to subventions, assistance due to debt cancellation, and the jute export duty is shown in the following table:

Provinces	Total subvention recommended	Assistance due to debt cancellation	Assistance due to jute export duty (lakhs of rupees)
Bengal	75		
Bihar	25	33	42
Central Provinces ..	15	22	2½
Assam	45	15	..
North-West Frontier		15½	2¼
Province	110	12	..
Orissa	50	9½	¼
Sind	105	..	..
United Provinces ..	25	..	..

After allowing for the advantage derived from the above sources, Sir Otto recommended that the annual grants-in-aid under section 142 of the Act charged on Central revenues should be as follows:

United Provinces ..	25 lakhs	(for a fixed period of five years)
Assam ..	30	(in addition to the grant for the Assam Rifles)
North-West Frontier Province ..	100	(subject to reconsideration at the end of five years)
Orissa ...	40	(increased to 47 lakhs in the first year and to 43 lakhs in the 2nd, 3rd, 4th, and 5th years)
Sind ..	105	(increased to 110 lakhs in the first year; subject to reductions set out in par. 13 of the Report)

Summary of Various Forms of Assistance

The various forms of assistance already given or recommended in the Report are:

(i) Cash subventions.

(ii) Fifty per cent of the jute duty.

(iii) Additional 12½ per cent of the jute duty.

(iv) Benefits from debt adjustment.

(v) Prospective shares from income-tax.

(vi) Relief through the creation of new provinces.

Table VII shows the assistance received by the provinces by each of these methods.

TABLE VII

FINANCIAL ASSISTANCE ALREADY GIVEN, PROPOSED TO BE GIVEN OR WHICH WILL BE EFFECTIVE IMMEDIATELY ON INTRODUCTION OF NEW CONSTITUTION (IN LAKHS)

PROVINCES		Relief from separation of Sind and Orissa (par. 11)	Subvention proposed by Sir Otto Niemeyer (par. 24)	50 per cent share of duty on jute (based on figures in par. 28)	Extra 12½ per cent of duty on jute proposed by Sir Otto Niemeyer (par. 22)	Benefit from consolidation and reduction or cancellation of debt (par. 21 and Appendix III)	Total	Share from income-tax which will accrue in full after 10 years on assumption that the amount surrendered by Government will be Rs. 6 crores		Total of columns (7) and (9) in lakhs	Percentage of total amount already surrendered by the Government of India
								Percentage	Amount (lakhs)		
(1)		(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)	
Madras	...	20	...	...	...	26.2	46.2	15	90	136.2	9.6
Bombay	...	90	...	...	...	14.5	104.5	20	120	224.5	15.7
Bengal	...	...	...	168	42	33	243	20	120	363	25.6
U.P.	...	...	25[1]	...	...	12.7	37.7	15	90	127.7	9
Punjab	...	8	...	...	...	1.7	1.7	8	48	49.7	3.5
Bihar	...	...	...	10	2.5	22	42.5	10	60	102.5	7.2
C.P.	...	...	...	...	...	20.9	20.9	5	30	50.9	3.6
Assam	...	...	30	9	2.25	15.5	56.75	2	12	58.75	4.3
N.W.F.P.	...	...	100[2]	...	...	12	112	1	6	118	8.3
Orissa	...	...	40[3]	1	0.25	9.5	50.75	2	12	62.75	4.4
Sind	...	...	105[4]	...	...	0.7	105.7	2	12	117.7	8.3
Total	...	118	300	188	47	168.7	821.7	100	600	1421.7	100

1 For a period of five years.
2 Subject to reconsideration at the end of five years.
3 Additional Rs. 7 lakhs will be given in the first year, and Rs. 3 lakhs of the next four years.
4 For a period of 10 years, to be reduced gradually thereafter (par. 13). In the first year an additional Rs. 5 lakhs to be given for the jail at Shikarpur.

Review of the Report

It is unnecessary to repeat once more that no financial arrangements in India can satisfy with complete justice the claims and counter-claims of the different provinces. It is, however, interesting to note the views of the Provincial Governments as set out in the Explanatory Memorandum on the Draft Orders.[1]

The Madras Government contended that its comparatively sound financial position was due to its policy of financial orthodoxy followed in balancing the budgets, through adequate taxation, in the economic depression. With reference to the distribution of income-tax it pointed out that Bombay with a population of 18 millions is disproportionately benefited by the allocation of 20 per cent, as against Madras with a population of 44 millions and an allocation of 15 per cent.[2]

The Bombay Government recorded an emphatic protest in regard to the recommendations of the Report as it took no steps to correct the position in which the Presidency had been placed by reason of the inequities and inherent unsoundness of the Meston Settlement, including the falsification of the forecast of revenue made by the Meston Committee, the complete failure of the anticipations of the Percy Committee, and the cost of development schemes in Bombay City undertaken at the behest of the Secretary of State.[3]

The Bengal Government was not satisfied with the allocation of 62½ per cent of the proceeds of the jute export duty and reiterated its claim that the entire proceeds of the duty should be credited to the Provincial Government. It asserted that Bengal can never rest content under a fiscal system which aims at protecting, largely at her expense as a consumer, the products of other provinces, while taxing her staple product for the benefits of the Centre, in other words for the benefit of other provinces.

The United Provinces Government accepted the general conclusions of Sir Otto Niemeyer but pointed out the peculiar position of the province on account of agrarian difficulties. For the last five years the province had been giving an annual remission

1 Cmd. 5181 (1936).
2 Letter dated May 5, 1936.
3 Letter dated May 5, 1936.
4 Letter dated May 6, 1936.

of Rs. 112 lakhs of land revenue which carried with it a remission of annual rent to tenants amounting to Rs. 4 crores. The Government suggested that the subvention should be raised to 40 lakhs (in place of 25) for each of the first three years and be fixed at 25 lakhs, as proposed in the Report, for the remaining two years.[1]

The Punjab Government made out a very strong case. It contended that the comparative stability of its revenues during the past three years was attributable to four main causes: (i) a high standard of taxation, (ii) drastic retrenchment, (iii) the strictest control over new expenditure, and (iv) favourable harvests.

Table VII points out the injustice to the Punjab. It is seen from the table that in the immediate relief amounting to 8,22 lakhs, the Punjab got 1.7 lakhs or one-fifth of one per cent. Out of the total relief which was estimated at 14.22 lakhs at the end of ten years, the Punjab would have received 49.7 lakhs or 3.5 per cent.

[1] Letter dated May 6, 1936.

VI

FEDERAL FINANCE UNDER THE CONSTITUTION

§1. *CONSTITUTIONAL BASIS*

In the preceding chapters we have described the development and working of the Indian financial system till the passing of the Constitution of India. With the independence of the country the political status of India underwent a fundamental change and the Constitution of India, passed on the 26th November 1949, has turned the country into a Sovereign Democratic Republic. The preamble to the Constitution secures to all the citizens of India :

JUSTICE, social, economic and political ;

LIBERTY of thought, expression, belief, faith and worship ;

EQUALITY of status and of opportunity ; and to promote among them all.

FRATERNITY assuring the dignity of the individual and the unity of the Nation.

It is not possible to enter here into any detailed discussion of the main features of the Constitution. However, a passing reference to some of the salient features is necessary in order to point out the effects of the Constitution on Indian federal finance. These changes may be described under two main heads, viz :

(1) Fundamental Rights and Directive Principles of State Policy ; and

(2) Distribution of Legislative Powers between the Union and the States.

Fundamental Rights

Indian federal finance in future would be profoundly influenced by the Fundamental Rights and Directive Principles of State Policy as provided for in the Constitution. Some of the important

Fundamental Rights which would influence the financial policy of the Government of India and State Governments are as follows :—

(1) All citizens shall have the right to acquire, hold and dispose of property.

(2) Traffic in human beings and *beggar* and other similar forms of forced labour are prohibited.

(3) No child below the age of fourteen years shall be employed to work in any factory or mine or engaged in any other hazardous employment.

(4) No person shall be compelled to pay any taxes, the proceeds of which are specifically appropriated in payment of expenses for the promotion or maintenance of any particular religion or religious denomination.

(5) No person shall be deprived of his property save by authority of law.

(6) No property, movable or immovable, including any interest in, or in any company owning, any commercial or industrial undertaking, shall be taken possession of or acquired for public purposes under any law authorising the taking of such possession or such acquisition, unless the law provides for compensation for the property taken possession of or acquired and either fixes the amount of the compensation, or specifies the principles on which, and the manner in which, the compensation is to be determined and given.

(7) If any Bill pending at the commencement of the Constitution in the Legislature of a State has, after it has been passed by such Legislature, been reserved for the consideration of the President and has received his assent, then, notwithstanding anything in the Constitution, the law so assented to shall not be called in question in any court on the ground that it contravenes the provisions of Article 31 Clause (2).

(8) Any law of the State enacted not more than eighteen months before the commencement of the Constitution may within three months from such commencement of the Constitution be submitted to the President for his certification; and thereupon, if the President by public notification so certifies, it shall not be called in question in any court on the ground that it contravenes

the provisions of Article 31 Clause (2) or has contravened the provisions of sub-section (2) of section 299 of the Government of India Act, 1935.

Directive Principles of State Policy

The Directive Principles of State policy are not enforceable by any court but the principles embodied in them are nevertheless of fundamental importance in the governance of the country and it shall be the duty of the State to apply these principles in making laws. The Constitution envisages that the State shall strive to promote the welfare of the people by securing and protecting as effectively as it may a social order in which justice, social, economic and political, shall inform all the institutions of the national life. The following are some of the important Directive Principles of State Policy :—

(1) The State shall direct its policy towards securing:

(a) that the citizens, men and women equally, have the right to an adequate means of livelihood;

(b) that the ownership and control of the material resources of the community are so distributed as best to subserve the common good;

(c) that the operation of the economic system does not result in the concentration of wealth and means of production to the common detriment;

(d) that there is equal pay for equal work for both men and women;

(e) that the health and strength of workers, men and women, and the tender age of children are not abused and that citizens are not forced by economic necessity to enter avocations unsuited to their age or strength;

(f) that childhood and youth are protected against exploitation and against moral and material abandonment.

(2) The State shall take steps to organise village *panchayats* and endow them with such powers and authority as may be necessary to enable them to function as units of self-government.

(3) The State shall, within the limits of its economic capacity and development, make effective provision for securing the right

to work, to education and to public assistance in cases of unemployment, old age, sickness and disablement, and in other cases of undeserved want.

(4) The State shall make provision for securing just and humane conditions of work and for maternity relief.

(5) The State shall endeavour to secure, by suitable legislation or economic organisation or in any other way, to all workers, agricultural, industrial or otherwise, work, a living wage, conditions of work ensuring a decent standard of life and full enjoyment of leisure and social and cultural opportunities and, in particular, the State shall endeavour to promote cottage industries on an individual or co-operative basis in rural areas.

(6) The State shall endeavour to provide, within a period of ten years from the commencement of the Constitution, for free and compulsory education for all children until they complete the age of fourteen years.

(7) The State shall promote with special care the educational and economic interests of the weaker sections of the people, and, in particular, of the Scheduled Castes and the Scheduled Tribes, and shall protect them from social injustice and all forms of exploitation.

(8) The State shall regard the raising of the level of nutrition and the standard of living of its people and the improvement of public health as among its primary duties and, in particular, the State shall endeavour to bring about prohibition of the consumption except for medicinal purposes of intoxicating drinks and of drugs which are injurious to health.

(9) The State shall endeavour to organise agriculture and animal husbandry on modern and scientific lines and shall, in particular, take steps for preserving and improving the breeds, and prohibiting the slaughter, of cows and calves and other milch and draught cattle.

Distribution of Legislative Functions

In chapter I we have described the principles underlying the distribution of functions between a federation and its units. The distribution of legislative powers between the Union and the States is more or less, on the lines of the Government of India Act,

1935. Under the Constitution there is a threefold distribution of legislative powers between the Union and the States, viz. Union List, Concurrent List and State List (Art. 246). Matters in which the Parliament has exclusive power to make laws are enumerated in List I in the Seventh Schedule to the Constitution (*i.e.* "Union List"). The Parliament and the Legislature of any State specified in Part A or Part B of the First Schedule, subject to certain restrictions, have power to make laws with respect to any of the matters enumerated in List III (*i.e.* "Concurrent List"). Finally, the Legislature of any Part A or Part B State has exclusive power to make laws for any of the matters enumerated in List II (*i.e.* "State List"). Thus defence of India; naval; military and air forces; foreign affairs; railways; shipping; public debt of the Union; Reserve Bank of India; post office; trade and commerce; banking; insurance; taxes on income other than agricultural income; duties of customs including export duties; duties of excise on tobacco and other goods manufactured or produced in India (except alcoholic liquors for human consumption); corporation tax; taxes on the capital value of the assets, exclusive of agricultural land, of individuals and companies; estate duty in respect of property other than agricultural land; duties in respect of succession to property other than agricultural land; terminal taxes on goods or passengers, carried by railway, sea or air; taxes on railway fares and freights; taxes other than stamp duties on transaction in stock exchanges and future markets; rates of stamp duty in respect of bills of exchange, cheques, promissory notes; taxes on the sale or purchase of newspapers and on advertisements published therein; are some of the important items enumerated in the Union List.[1]

It is important to mention that the residuary powers of legislation vest in the Parliament. Thus Parliament has exclusive power to make any law with respect to any matter not enumerated in the Concurrent List or State List. Such power includes the power of making laws imposing a tax not stated in either of the above Lists.

The Legislature of any Part A or Part B State has power to

[1] For a complete list of the legislative powers of the Union and the States, see Appendix III.

make laws regarding public order; police; local self-government; public health; sanitation; hospitals and dispensaries; production; manufacture and sale of intoxicating liquors; education; agriculture; forests; betting and gambling; land revenue; taxes on agricultural income; duties in respect of succession to agricultural land; estate duty in respect of agricultural land; taxes on lands and buildings; taxes on mineral rights subject to any limitations imposed by Parliament by law relating to mineral development; duties of excise on alcoholic liquors for human consumption; opium, Indian hemp and other narcotic drugs and narcotics; taxes on the entry of goods into a local area for consumption, use or sale; taxes on the consumption or sale of electricity; taxes on goods and passengers carried by road or on inland waterways; taxes on vehicles; taxes on animals and boats; tolls; taxes on professions, trades, callings and employments; capitation taxes; taxes on luxuries, including taxes on entertainments, amusements; betting and gambling; and rates of stamp duty in respect of documents other than those specified in the provisions of List I with regard to rates of stamp duty.

Finally, the important matters stated in the Concurrent List are economic and social planning; commercial and industrial monopolies, combines and trusts, trade unions; industrial and labour disputes; welfare of labour including conditions of work, provident fund, employer's liability, workmen's compensation, invalidity and old age pensions and maternity benefits; price control; factories; boilers; electricity; newspapers, books and printing presses; stamp duties other than duties or fees collected by means of judicial stamps, but not including rates of stamp duty.

The need for a Concurrent List of subjects, over which the Union and the States have Concurrent powers of legislation, is uniformity. The Joint Parliamentary Committee on Indian Constitutional Reforms (1934) observed that experience has shown, both in India and elsewhere, that there are certain matters which cannot be allocated exclusively either to a Central or to a Provincial Legislature, and for which, though it is often desirable that Provincial legislation should make provision, it is equally necessary that the Central Legislature should also have a legislative jurisdiction, to enable it in some cases to secure uniformity

in ths main principles of law throughout the country; in others to guide and encourage provincial efforts, and in others again to provide remedies for mischiefs arising in the provincial sphere but extending or liable to extend beyond the boundaries of a single province.

Instances of the first are provided by the subject-matter of the great Indian Codes; of the second by such matters as labour legislation, and of the third by legislation for the prevention and control of epidemic disease.

It would be disastrous if the uniformity of law which the Indian Codes provide were destroyed or whittled away by the un-co-ordinated action of Provincial Legislatures. On the other hand, local conditions necessarily vary from Province to Province, and Provincial Legislatures ought to have the power of adapting general legislation of this kind to meet the particular circumstances of a province.[1]

Conclusions

Such, in brief, are the broad characteristics of the Constitution in the field of the distribution of the legislative powers between the Union and the States. The rationale of the division of the taxing powers follows closely the above division of the legislative functions. Broadly speaking it may be said that the Indian Constitution is a highly centralized federal Constitution and in the sphere of taxing powers that type of simple dichtomy reserving indirect taxes to Federation and direct taxes to State is not found in the Constitution. The rival claims of centralisation and decentralisation in federal finance which would baffle even the most ingenious administrator have been solved in a most satisfactory manner. This is perhaps the most important feature of the Constitution. To this we come in Section II of this chapter.

Above all, the nature and composition of the Indian tax structure would be profoundly influenced by the Fundamental Rights and Directive Principles of State Policy. Similarly, public expenditure would be guided by two main objectives; viz., (1) to provide a better standard of life for the people; and (2) social justice. Economic equality is the ideal to be achieved under the

[1] See the *Report on Joint Parliamentary Committee on Indian Constitutional Reforms* 1934 par. 51.

Constitution. At present there are large inequalities in the distribution of wealth between the rich and the poor, between the urban and rural areas. The Constitution has suggested fiscal and legislative measures to bring about economic equality. Since taxation alone would not achieve this objective the Constitution lays emphasis on changing the economic pattern of the country. Democracy in India can only survive through a radical change in land policy. Abolition of zamindari is the first step towards the creation of a Welfare State in India. The other method is to divert public expenditure to raise the standard of life of the common man through improvement in the economic and social status of the more vulnerable classes and through increase in the wealth and production capacity of the community as a whole. Protection of tenants, labour welfare, amelioration of the backward classes and the substitution of usury by organized credit are steps to this end. Agricultural development and promotion of cottage industries on an individual or co-operative basis, through State help, will go a long way towards rectifying the prevailing inequalities.

It should, however, be borne in mind that there are real dangers in bringing a too rapid change in the economic pattern of the country. Firstly, Indian economy is not fully integrated. Secondly, a large section of our economy responds slowly to economic stimuli. But a static social ideal cannot co-exist with a progressive economic ideal. Finally, the federal structure of the Constitution in which the States are largely autonomous in providing social services, involves problems of effective co-ordination of policies and programmes between the Union and the States. The States would play in future the most important rôle in changing the economic and social pattern of the country. Thus a carefully planned integrated financial system of the country as a whole is the most important need of the day.

§2. *DISTRIBUTION OF REVENUES BETWEEN THE UNION AND THE STATES*

The Constitution has, to a large extent, followed the allocation of revenues between the Federation and the States on the lines of the Government of India Act, 1935. With the entry of the former Indian States into the Federation the question both of

allocation of revenues and distribution of grants-in-aid has become one of formidable difficulty. In order to understand the present allocation of revenues between the Federation and the States it is essential to study the subject in two parts : *first,* the allocation of revenue between the Federation and the States; and *second,* the distribution of grants-in-aid. Under the Constitution the sources of revenue due to the Federation and the States have been allocated thus:

A. *State Sources of Revenue*

The following taxes are levied and collected by the States:—

1. Land Revenue, including the assessment and collection of revenue.
2. Taxes on agricultural income.
3. Duties in respect of succession to agricultural land.
4. Estate duty in respect of agricultural land.
5. Taxes on lands and buildings.
6. Taxes on mineral rights, subject to any limitation imposed by Parliament by law relating to mineral development.
7. Duties of excise on the following goods manufactured or produced in the State and countervailing duties at the same or lower rates on similar goods manufactured or produced elsewhere in India:—
   (a) alcoholic liquors for human consumption ;
   (b) opium, Indian hemp and other narcotic drugs and narcotics ;

   but not including medicinal and toilet preparations containing alcohol or any substance included in sub-paragraph (b) of this entry.

   (b) opium, Indian hemp and other narcotic drugs and narcotics ; but not including medicinal and toilet preparations containing alcohol or any substance.
8. Taxes on the entry of goods into a local area for consumption, use or sale therein.
9. Taxes on the consumption, or sale of electricity.
10. Taxes on the sale or purchase of goods other than newspapers.

11. Taxes on advertisements other than advertisements published in the newspapers.
12. Taxes on goods and passengers carried by road or inland waterways.
13. Taxes on vehicles, whether mechanically propelled or not suitable for use on roads, including tramcars (Subject to the provisions of entry 35 of List, *i.e.*, Concurrent List.)
14. Taxes on animals and boats.
15. Tolls.
16. Taxes on professions, trades, calling and employments.
17. Capitation taxes.
18. Taxes on luxuries, including taxes on entertainments amusements, betting and gambling.
19. Rates of stamp duty in respect of documents other than those specified in the provisions of List 1 (*i.e.*, Union List) with regard to the stamp duty.
20. Fees in respect of any of the matters in List II, but not including fees taken in any court.

B. *Taxes Levied and Collected by the Union but Assigned to the States*

The following duties and taxes shall be levied and collected by the Government of India but the net proceeds in any financial year of any such duty or tax (except the proceeds attributable to States specified in Part C of First Schedule) shall be distributed among those States in accordance with such principles of distribution as may be formulated by Parliament by law :—

(a) duties in respect of succession to property other than agricultural land;
(b) estate duty in respect of property other than agricultural land;
(c) terminal taxes on goods or passengers carried by railway, sea or air;
(d) taxes on railway fares and freights;
(e) taxes other than stamp duties on transactions in stock exchanges and future markets;
(f) taxes on the sale or purchase of newspapers and on advertisements published therein.

C. *Duties Levied by the Union but Collected and Appropriated by the States*

Under the Constitution such stamp duties and duties of excise on medicinal and toilet preparations as are mentioned in the Union List shall be levied by the Government of India but shall be collected:—

(a) in the case where such duties are leviable within any state specified in Part C of the First Schedule, by the Government of India, and

(b) in other cases, by the States within which such duties are respectively leviable.

D. *Taxes which shall be levied taxes and collected by the Union, but the proceeds shall be distributed between the Union and the States*

(1) Taxes on income other than agricultural income.

(2) Union duties of excise other than such duties of excise on medicinal and toilet preparations as are mentioned in the Union List and collected by the Government of India.

Union Taxation

The principal items of revenue stated in the Union List are as follows:—

1. Railways.
2. Posts and telegraphs, telephones, wireless, broadcasting and other like forms of communication.
3. Property of the Union and the revenue therefrom, but as regards property situated in a State specified in Part A or Part B of the First Schedule subject to legislation by the State, save in so far as Parliament by law otherwise provides.
4. Public debt of the Union.
5. Currency, coinage and legal tender; foreign exchange.
6. Foreign loans.
7. Reserve Bank of India.
8. Post Office Savings Bank.
9. Lotteries organised by the Government of India or the Government of a State.
10. Taxes on income other than agricultural income.

11. Duties of customs including export duties.
12. Duties of excise on tobacco and other goods manufactured or produced in India except—
    (a) alcoholic liquors for human consumption;
    (b) opium, Indian hemp and other narcotic drugs and narcotics;

    but including medicinal and toilet preparations containing alcohol or any substance included in sub-paragraph (b) of this entry.
13. Corporation tax.
14. Taxes on the capital value of the assets, exclusive of agricultural land, of individuals and companies; taxes on the capital of companies.
15. Estate duty in respect of property other than agricultural land.
16. Terminal taxes on goods or passengers, carried by railway, sea or air; taxes on railway fares and freights.
17. Taxes other than stamp duties on transactions in stock exchanges and future markets.
18. Rates of stamp duty in respect of bills of exchange, cheques, promissory notes, bills of lading, letters of credit, policies of insurance, transfer of shares, debentures, proxies and receipts.
19. Taxes on the sale or purchase of newspapers and on advertisements published therein.
20. Fees in respect of any of the matters in the Union List, but not including fees taken in any court.

§3. *DISTRIBUTION OF INCOME TAX AND JUTE EXPORT DUTY*

Distribution of Income-tax

It will appear from the above allocation of resources between the Union and the States, that the most important changes in the allocation, as compared with the Government of India Act, 1935, have been made regarding income-tax, jute export duty, sales tax and salt tax.

The Government of India Act, 1935 laid down fixed percentages for the distribution of income-tax between the Centre

and the Provinces. The actual allocation, however, was left to Sir Otto Niemeyer. Sir Otto fixed the Provincial share at 50 per cent and distributed the said percentage among the Provinces. Under the Constitution the percentage of the net proceeds of the income-tax in any financial year (except the proceeds which represent proceeds attributable to States specified in Part II of the First Schedule or taxes payable in respect of the Union emoluments) shall be distributed among the States in a manner as may be prescribed by Parliament. For this purpose a Finance Commission shall be constituted by the President and the net proceeds available for distribution shall be prescribed by the President by Order after considering the recommendation of the Finance Commission. Until a Finance Commission is appointed the percentage and the manner of distribution among the States of the net proceeds of income-tax shall be prescribed by the President by Order. Thus, it will appear that the position of the States in respect of the distribution of income-tax is now weaker than what it was under the Act of 1935; the States possess no constitutional right of a fixed percentage of income-tax.

The Finance Commission, as pointed out above, shall recommend to the President the distribution of income-tax. Meanwhile, the President under Clauses 2 and 3 of Article 270 has passed the following Order regarding the distribution of income-tax. Paragraph 3 of this Order runs as follows[1] :—

(1) "For the purpose of Clause (2) of Article 270, one per cent of the net proceeds of taxes on income as does not represent the net proceeds of taxes payable in respect of Union emoluments shall be deemed to represent the proceeds attributable to Part C States in the financial year commencing on the first day of April, 1950.

(2) The percentage of the net proceeds of the taxes on income, except in so far as those proceeds represent proceeds attributable to Part C States or to taxes payable in respect of Union emoluments, which is to be assigned to Part A States and Part B States under the said clause in the said financial year, shall be

1. Vide *Government of India Gazette* (Extraordinary) April 15, 1950.

fifty per cent.

(3) The sums falling to be distributed under the said clause in the said financial year among Part A States and Part B States shall be distributed in the following manner, namely—

(*a*) each Part B State shall be entitled to receive out of the said sums a sum equivalent to fifty per cent of the net proceeds of the taxes on income other than agricultural income levied and collected by the Government of India in that State in the said financial year:

Provided that if any such State is entitled to receive in the said financial year any grant of financial assistance by the Government of India by virtue of an agreement under Clause (1) of Article 278, then the sum payable to that State under this sub-paragraph shall be reduced by the amount of the said grant;

(*b*) each Part A State shall be entitled to receive out of the said sums a sum equivalent to fifty per cent of the net proceeds of the taxes on income other than agricultural income levied and collected by the Government of India in the merged territories within that State in the said financial year; and

(*c*) after deducting the sums referred to in sub-paragraphs (a) and (b) from the said sums, the balance shall be distributed as follows:—

States		*Per cent*
Assam	...	3
Bihar	...	12.5
Bombay	...	21
Madhya Pradesh	...	6
Madras	...	17.5
Orissa	...	3
Punjab	...	5.5
Uttar Pradesh	...	18
West Bengal	...	13.5

The President, under the Distribution of Revenues Order of 1950, has passed the following Order for grants-in-aid.:—

"In accordance with the provisions of Clause (1) of Article 273 and Clause (1) of Article 275, there shall be charged on the Consolidated Fund of India, in the said financial year as grants-in-aid of the revenues of each of the States specified below the sum or sums specified against it in addition to any sum payable to that State under either of the Provisos to Clause (1) of Article 275:[1]

States	*Under Article 273*	*Under Article 275*
Assam	Rs. 40,00,000	Rs. 30,00,000
Bihar	Rs. 35,00,000	Rs. Nil
Orissa	Rs. 5,00,000	Rs. 40,00,000
Punjab	Rs. Nil	Rs. 75,00,000
West Bengal	Rs. 105,00,000	Rs. Nil

Distribution of Export Duty on Jute

Under the Government of India Act, 1935 not less than half of the net proceeds of the export duty on jute in each year was to be assigned to the Provinces in which jute was grown in proportion to the respective amount of jute grown therein. The Act, however, left to Sir Otto Niemeyer to fix the exact percentage and its distribution among the Provinces. Sir Otto had recommended that the percentage under section 140(2) of the Government of India Act, 1935, should be increased to 62½ on the estimated gross yield of the duty in 1936-37. Under the Constitution the export duty on jute and jute export products shall not be divided between the Union and the jute growing States, but in lieu of the jute export duty, grants-in-aid out of the Consolidated Fund of India shall be paid each year to the States of Assam, Bihar, Orissa and West Bengal as may be prescribed either by the President before the appointment of the Finance Commission or by the Commission itself. The grant-in-aid so prescribed shall continue to be a charge on the Consolidated Fund of India so long as any export duty on jute or jute products continues to be levied by the Government of India, or

[1] Vide *Gazette of India* (Extraordinary) April 15, 1950.

until the expiration of ten years from the commencement of the Constitution, whichever is earlier.

From the above provisions it will appear that the jute export duty which under the Act of 1935, formed a definite source of revenue in the Provinces, has now been taken away by the Union. In view of the attitude of Pakistan towards the jute export trade and the uncertainty which prevails in the trade itself, it is difficult to envisage the yield of the duty in future. Liberal grants in lieu of the duty should be welcome to the jute growing States.

§4. *MISCELLANEOUS PROVISIONS*

Surcharges on Duties and Taxes

The Union Government (notwithstanding the provisions of Articles 269 and 270) may levy duties or taxes by a surcharge for purposes of the Union; and the whole proceeds of any surcharge, shall form part of the Consolidated Fund of India. Such a proposal was made by the White Paper (December 1931) which proposed that the Federal Government may be empowered to impose a surcharge on taxes on income, the proceeds of which were to be devoted solely for Federal purposes. Similarly, the provincial legislatures were to be empowered to impose a surcharge, not exceeding 12½ per cent, on the taxes levied on the personal income of persons resident in the provinces and to retain the proceeds for their own purpose. The Joint Committee (1934), however, did not favour the levy of the surcharges and they were not permitted by the Act of 1935. The provisions of the above Articles have given powers to the Union Parliament alone to levy these surcharges but no corresponding power has been given to the States. This again weakens the position of the States in financial matters and they must look to the Union for grants.

Taxes on Professions, Trades, Callings and Employments

The legislature of a State (notwithstanding anything contained in Article 246) shall not pass a law regarding taxes on professions, trades, callings and employments, the total amount payable in respect of any one person to the State or to any one municipality,

district board, local board, or other local authority in the State, shall exceed Rs. 250/- per annum.

Bills Affecting Taxation in which States are interested

The Constitution requires the prior recommendation of the President to Bills which affect taxation in which States are interested. Thus no Bill or amendment which imposes or varies the meaning of the expression "agricultural-income", or which affects the principle on which moneys are or may be distributed to States or which imposes any surcharge for the purposes of the Union (Article 271) shall be introduced or moved in the House of Parliament except on the recommendation of the President. The Article thus safeguards the interests of the States in those fields of taxation in which they are interested by making it obligatory on the part of the Union Government to obtain the recommendation of the President before introducing such a Bill which may change their financial position.

Finance Commission

One of the most important financial provisions of the Constitution is the constitution of a Finance Commission. The President shall, within two years from the commencement of the Constitution and at the expiry of every fifth year or at such times as he thinks necessary, constitute a Finance Commission which shall consist of a Chairman and four members to be appointed by the President. Parliament may by law determine the qualifications necessary for appointment of the members of the Commission and lay down the manner in which they shall be selected.

The Commission shall make recommendations to the President regarding:—

(a) the distribution between the Union and the States of the net proceeds of taxes which are to be, or may be, divided between them and the allocation between the States of the respective shares of such proceeds ;

(b) the principles which should govern the grants-in-aid of the revenues of the States out of the Consolidated Fund of India ;

[1] For a summary of the main recommendations of the Finance Commission (1953), see Appendix V.

(c) the continuance or modification of the terms of any agreement entered into by the Government of India with the Government of any State specified in Part B of the First Schedule under Clause (1) of Article 278 or under Article 306; and

(d) any other matter referred to the Commission by the President in the interests of sound finance.

The Finance Commission shall, thus, recommend to the President—

(i) the percentage of the net proceeds of the taxes which may be divided between the Union and the States;

(ii) the allocation of the share of the proceeds of such percentages between the States *inter se;*

(iii) the principles which shall govern the distribution of grants-in-aid of the revenues out of the Consolidated Fund of India between the States;

(iv) the continuance or modification of the terms of agreement with Part B States regarding the levy of internal customs and duties. This has become necessary as a result of the integration of the former Indian States with the Union;

(v) grants-in-aid for tribal areas; and

(vi) special grants for Assam.

The Commission shall determine its procedure and shall have such powers in the performance of its functions as Parliament may by law confer on it.

The President shall place every recommendation made by the Commission together with an explanatory memorandum as to the action taken on them before each House of Parliament.

Examination of Agreement with Part B States[1]

The Finance Commission shall also examine the cases of

[1] Article 291 Clause (1) runs as follows:—

"Where under any covenant or agreement entered into with the Ruler of any Indian State before the commencement of this Constitution, the payment of any sums, free of tax, has been guaranteed or assured by the Government of the Dominion of India to any Ruler of such State as privy purse"—

(a) such sums shall be charged on, and paid out of, the Consolidated Fund of India; and

(b) the sums so paid to any Ruler shall be exempt from all taxes on income.

agreements entered into between the Government of India and a State specified in Part B of the First Schedule with respect to—

(a) the levy and collection of any tax or duty leviable by the Government of India in such State and for the distribution of the proceeds thereof otherwise than in accordance with the provisions of Chapter II of the Constitution;

(b) the grant of any financial assistance by the Government of India to such State in consequence of the loss of any revenue which that State used to derive from any tax or duty leviable under the Constitution by the Government of India or from any other sources;

(c) the contribution by such State in respect of any payment made by the Government of India under Clause (1) of Article 291 and when an agreement is so entered into, the provisions of Chapter XII shall in relation to such State have effect subject to the terms of such agreement.

The President may, on the report of the Finance Commission, terminate or modify any such agreement. Similarly, the Finance Commission shall examine the cases of the States in Part B of the First Schedule, which before the commencement of the Constitution were levying any tax or duties on the import of goods into the State from other States or on the export of goods from the State to other States. If an agreement has been reached and entered into between the Government of India and the Government of a State, the State may continue to levy and collect such tax or duty subject to the terms of such agreement, and for such period not exceeding ten years from the commencement of the Constitution. The President may, however, after the expiration of five years from such commencement, terminate or modify any such agreement after considering the report of the Finance Commission. Thus the Finance Commission has to examine the cases of the States in Part B of the First Schedule in terms of Articles 278 and 306.

Grants from Union to States

The Constitution empowers Parliament to pay out of the Consolidated Fund of India in each year as grants-in-aid of the revenues of such States as Parliament may determine to be in need of assistance. The grants so fixed may differ from State to State.

Under Article 275 Parliament may by law provide for the distribution of grants-in-aid among the States as may be in need of assistance, and different sums may be fixed for different States. The Constitution has laid down that out of the Consolidated Fund of India grants-in-aid shall be paid, as may be necessary, to enable a State to meet the cost of such schemes of development as may be undertaken by the State with the approval of the Government of India for the purpose of promoting the welfare of the Scheduled Tribes in that State, or raising the level of administration of the Scheduled Areas therein to that of the administration of the rest of the areas of that State.

Besides, there shall be paid out of the Consolidated Fund of India as grants-in-aid of the revenues of the State of Assam sums, capital and recurring equivalent to:—

(i) the average excess of expenditure over the revenues during the two years immediately preceding the commencement of the Constitution in respect of the administration of the tribal areas specified in Part A of the table appended to paragraph 20 of the Sixth Schedule; and

(ii) the costs of such schemes of development as may be undertaken by Assam with the approval of the Government of India for the purpose of raising the level of administration of the said areas to that of the administration of the rest of the areas of the State.

The Finance Commission thus shall recommend the payment of :

(i) *ad hoc* grants-in-aid to any State in India;

(ii) grants-in-aid to States for the promotion of the welfare of the Scheduled Tribes; and

(iii) special grants-in-aid to Assam.

VII

THE FINANCIAL SYSTEM AND ADMINISTRATION

§ 1. *INTRODUCTORY*

In most federal constitutions there are three fundamental provisions in the field of financial administration which safeguard the interests of taxpayers. Briefly, the rights of the taxpayers are that :—

(1) No tax shall be levied or collected unless it is approved by the representatives of the people ;

(2) No expenditure out of public revenue is incurred unless it is sanctioned by Parliament ; and

(3) The executive spends the public revenue exactly in the manner as passed by Parliament. In order to check the abuse of power on the part of the executive, the Auditor-General audits the accounts of the Government to place before the Legislature a report to show that the executive has spent the money for the purposes for which Parliament had sanctioned it.

The Constitution has provided safeguards for the above three rights. Thus, "No tax shall be levied or collected except by authority of law".[1] Similarly, no moneys out of the Consolidated Fund of India or the Consolidated Fund of a State shall be appropriated except in accordance with law, and for the purpose and in the manner as passed by the Legislature.[2] Again, the Comptroller and Auditor-General of India has been given duties and powers to check the expenditure of the Government of India and the State Governments.[3] The Report of the Comptroller and Auditor-General shall be laid before each of the Houses of Parliament and the Legislatures of the States in order that the representatives of

[1] Vide Article 265.
[2] Vide Article 266.
[3] Vide Article 148.

the people may have the chance to see that public revenues have not been diverted from the purposes of expenditure for which they were allocated by the House.

The scope of this chapter is as follows :—

First, an account shall be given of the procedure in respect of Money Bills in the case of the Union and State Legislatures. This shall be followed by provisions relating to the borrowing powers by the Government of India and the States. Finally, the duties and powers of the Comptroller and the Auditor-General will be described.

Summary of Financial Procedure in the Union Parliament

Before we describe in any detail the special procedure for the passing of Money Bills in the Union Parliament, it is desirable to summarise briefly the various stages of financial machinery as followed in the Indian Parliament. These stages are as follows :—

A. *Presentation of the Annual Financial Statement*

After the estimates have been prepared by the various departments of the Government, the Annual Financial Statement for the coming year is laid before both the Houses of Parliament. The Annual Financial Statement shall contain the estimates of the receipts as well as the expenditure of the Union Government. The expenditure shall be classified as follows :—

(i) Expenditure charged upon the Consolidated Fund and items which are not so charged ; and

(ii) Expenditure on revenue account and on other accounts.

B. *General Discussion*

After the Financial Statement has been presented to the Houses a general discussion takes place in both the Houses. It may be pointed out that no item of expenditure is exempt from general discussion. Expenditure charged upon the Consolidated Fund though not subject to the vote of the House, is equally open for discussion. The general discussion is upon matters relating to policy including a review and criticism of the administration of the Government and its departments. The members of the Legislature, thus, have a chance of ventilating the grievances of the taxpayers.

C. *Vote of the Demands by the House of the People*

In the House of the People, after the general discussion has taken place, the estimates shall be submitted to the House in the form of demands for grants on particular heads of expenditure followed by the vote of the House for each item of expenditure. The House of the People possesses three powers in this respect: (i) to assent to the demand; (ii) to refuse it; and (iii) to reduce it. It will thus appear that the House has no power to increase the demand or to change the allocation of expenditure from one head to another. The voting of the demands for grants does not take place in the Council of States.

D. *The Appropriation Act*

After the grants have been voted by the House of the People, they shall be presented to the House in the form of an Appropriation Act. Under the Government of India Act, 1935, after the demands had been voted by the Legislature, the Governor-General authenticated the Finance Bill under his signature. Where the expenditure had been refused or reduced by the Legislature, but was in his opinion necessary for the discharge of his special responsibilities, he restored the expenditure in the original form as put forth before the House. In England, the grants, as voted by the House of Commons, are embodied in a Money Bill and passed by Parliament. Under the Constitution, the President has no power to override the vote of the House of the People. The Appropriation Act is the sole legal authority for any appropriation of money out of the Consolidated Fund of India.

E. *The Finance Act*

The new tax proposals of the budget shall be embodied in another bill and passed as the Annual Finance Act of the year.

§ 2. *FINANCIAL ADMINISTRATION*

Consolidated Fund and Contingency Fund

The Constitution has created two funds in the case of the Government of India, viz: (1) The Consolidated Fund, and (2) The Contingency Fund. Similar Funds have also been created in the case of the States. The whole or part of the net proceeds of

certain taxes and duties and all revenues received by the Government of India, and all loans raised by it by the issue of treasury bills, loans, or ways-and-means advances, in short, all moneys received or owned by the Government of India, shall form one Consolidated Fund to be entitled 'the Consolidated Fund of India'.

Similarly all revenues, loans, or ways-and-means advances and all moneys received by the States from the Government of India shall be entitled 'the Consolidated Fund of State'.[1]

The Parliament may by law establish a Contingency Fund in the nature of an imprest to be entitled 'the Contingency Fund of India', into which shall be paid from time to time such sums as may be determined by laws passed by Parliament. The Fund shall be placed at the disposal of the President to enable him to make advances for the purposes of meeting unforeseen expenditure, pending authorisation for such expenditure by Parliament under the provisions of Articles 115 or 116.

The Legislature of a State may also establish a similar Contingency Fund in the nature of an imprest to be entitled 'the Contingency Fund of the State'. The Fund shall be placed at the disposal of the Governor or Rajpramukh of the State to enable him to make advances for the purpose of meeting unforeseen expenditure pending its authorisation by the Legislature of the States under Articles 205 or 206.

The Consolidated Fund is the foundation-stone of financial control in England. All the public revenues received by the State are paid into the Consolidated Fund which is kept in the Bank of England, and no amount can be withdrawn except under the authority of an Act of Parliament. Similarly the Australian Constitution provides: "All revenues or moneys raised or received by the Executive Government of the Commonwealth shall form one Consolidated Revenue Fund, to be appropriated for the purposes of the Commonwealth in the manner and subject to the charges and liabilities, imposed by the Constitution". (Section 81)

Under English financial practice, besides the Consolidated Fund there is also the Civil Contingency Fund, the amount of

[1] Vide Article 266.

which is fixed by statute. The Fund provides expenditure for:—(i) established services where the grant has not yet been formally voted; (ii) departments for which Parliament has made no provisions in the estimates for the year; and (iii) departments which have exhausted the sums appropriated under votes. The moneys spent by the Government from this Fund are later voted by Parliament and then repaid to the Fund either before or after the close of the financial year. The accounts of the Fund are also scrutinised by the Public Accounts Committee. Under the Constitution a Contingency Fund has been constituted to enable the Government of India and State Governments to meet unforeseen expenditure, pending authorisation of such expenditure, in the shape of supplementary, additional or exceptional grants by the House of the People or the Legislative Assembly of the State.

The custody of the Consolidated Fund and the Contingency Fund of India, the payment of moneys into such Funds, the withdrawal of moneys from them and all transactions connected with them shall be regulated by laws made by Parliament. The President is authorised, till such rules are made by Parliament, to regulate the custody of such Funds by rules made by him.[1]

The custody of the Consolidated Fund and the Contingency Fund of a State and all the transactions, the payments of money into such Funds, the withdrawal of money from them shall be regulated by law made by the Legislature of the States and until such laws are framed, by rules made by the Governor or Rajpramukh of the State.[2]

Initiation of Money Bills

The power of initiating Money Bills is, more or less, common to all leading constitutions. The rule that Money Bills may originate in the House of Commons in England, is not sanctioned by any statute, but is the result of the tenacious and continuous struggle between the people and the Crown, which had its first victorious affirmation in the *Magna Carta* of 1215, and ended in 1688 with the recognition of the Sovereignty of Parliament in the matter of levying taxes. The House of Lords, however, had the

[1] Vide Article 283 (1).
[2] Vide Article 283 (2).

power to amend or reject Money Bills passed by the House of Commons. This power of the House of Lords was stopped by the Parliament Act, 1911 under which the Lords can neither amend nor reject a Money Bill; the utmost the House of Lords can do is to prevent a Money Bill from becoming law for a period of one month. Section 1 (I) of the Parliament Act, 1911 lays down—

If a Money Bill, having been framed by the Commons and sent to the Lords at least one month before the end of the session, is not passed by the Lords without amendment within one month after it has been sent up, the Bill, unless the Commons direct to the contrary, shall be presented to the King and become a statute on receipt of the Royal Assent without the consent of the Lords.

The Indian Constitution has followed the practice of other constitutions and Money Bills in the case of the Union can only be introduced in the House of the People. In States where there is a Legislative Council, besides a Legislative Assembly, a Money Bill can only be introduced in the Legislative Assembly.

Definition of "Money Bills"

A Bill is deemed to be a Money Bill if it contains provisions dealing with any or all of the following matters namely :[1]

(a) the imposition, abolition, remission, alteration or regulation of any tax;

(b) the regulation of the borrowing of money or the giving of any guarantee by the Government of India, or the amendment of the law with respect to any financial obligations undertaken or to be undertaken by the Government of India;

(c) the custody of the Consolidated Fund or the Contingency Fund of India, the payment of moneys into or the withdrawal of moneys from any such fund;

(d) the appropriation of moneys out of the Consolidated Fund of India;

(e) the declaring of any expenditure to be expenditure charged on the Consolidated Fund of India or the increasing of the amount of any such expenditure;

[1] Vide Article 110. For definition of Money Bills in States see Article 199. Article 110 exactly corresponds to Article 199.

(f) the receipt of money on account of the Consolidated Fund of India or the public accounts of India or the custody or issue of such money or the audit of the accounts of the Union or of a State.

(g) any matter incidental to any of the matters specified in clause (a) to (f) above.

Procedure for Passing Money Bills

A Money Bill in the case of the Union shall not be introduced in the Council of States.[1]

After a Money Bill has been passed by the House of the People it shall be transmitted to the Council of States for its recommendations and the Council of States shall within a period of fourteen days from the date of the receipt of the Bill, return the Bill to the House of the People with its recommendations and the House of the People may thereupon either accept or reject all or any of the recommendations of the Council of States.

If the House of the People accepts any of the recommendations of the Council of States, the Money Bill shall be deemed to have been passed by both Houses with the amendments recommended by the Council of States and accepted by the House of the People.

If the House of the People does not accept any of the recommendations of the Council of States, the Money Bill shall be deemed to have been passed by both Houses in the form in which it was passed by the House of the People without any of the amendments recommended by the Council of States.

If a Money Bill passed by the House of the People and transmitted to the Council of States for its recommendations is not returned to the House of the People within the said period of fourteen days, it shall be deemed to have been passed by both Houses at the expiration of the said period in the form in which it was passed by the House of the People.

Annual Financial Statement

The President shall in respect of every financial year cause to be laid before both the Houses of Parliament a statement of the

[1] Vide Article 109. For the procedure of passing of Money Bills in States see Article 198, which exactly corresponds with Article 109.

estimated receipts and expenditure of the Government of India for that year. This statement is called the 'Annual Financial Statement'.

The estimates of expenditure embodied in the Annual Financial Statement shall show separately :—

(a) The sums required to meet expenditure described by the Constitution as expenditure charged upon the Consolidated Fund of India ; and

(b) the sums required to meet other expenditure proposed to be made from the Consolidated Fund of India.

The Financial Statement shall also distinguish expenditure on revenue account from other expenditure.[1]

Expenditure charged on the Consolidated Fund

The following expenditure shall be expenditure charged upon the Consolidated Fund of India :[2]

(a) the emoluments and allowances of the President and other expenditure relating to his office;

(b) the salaries and allowances of the Chairman and the Deputy Chairman of the Council of States and the Speaker and the Deputy Speaker of the House of the People ;

(c) debt charges for which the Government of India is liable including interest, sinking fund charges and redemption charges, and other expenditure relating to the raising of loans and the service and redemption of debt ;

(d) (i) the salaries, allowances and pensions payable to or in respect of Judges of the Supreme Court ;

(ii) the pensions payable to or in respect of Judges of the Federal Court ;

(iii) the pensions payable to or in respect of Judges of any High Court which exercises jurisdiction in relation to any area included in a Province corresponding to a State specified in Part A of the First Schedule ;

1 Vide Article 112. Compare this Article with Article 202 for the States.
2 Vide Article 112. See Article 202 (3) for the States.

(e) the salary, allowances and pension payable to or in respect of the Comptroller and Auditor-General of India;

(f) any sums required to satisfy any judgement, decree or award of any court or arbitral tribunal;

(g) any other expenditure declared by the Constitution or by Parliament by law to be so charged.

Broadly speaking, the expenditure 'charged on the Consolidated Fund of India', more or less, corresponds to the Consolidated Fund Services of England. The enumeration of the items charged on the Consolidated Fund is not exhaustive and Parliament is empowered to add more to the list by law.

The fundamental reason for making some expenditure free from the vote of the House, is that the persons who have been charged with the responsibilities for the carrying out of the functions of the Government should be independent of the vote of the House. A disproportionately higher expenditure charged on the Consolidated Fund, however, reduces the power of the Legislature in controlling public expenditure.

No money shall be withdrawn from the Consolidated Fund of India unless it was included in the Appropriation Bill as passed by the House of the People.[1]

Importance of Supplementary Grants

Supplementary grants occupy an important place in financial administration. In England, a supplementary grant may be presented either for a further grant to a service already sanctioned by Parliament, in addition to the sum already demanded for the current financial year, or for a grant caused by a fresh occasion for expenditure that has arisen since the presentation of the sessional estimates, such as expenditure newly imposed upon the executive government by statute, or to meet the cost created by an unexpected emergency, such as an immediate addition to an existing service, or the purchase of land, or of a work of art. The need for a supplementary grant to an existing service is not infrequently caused by the system in force to ensure the control of Parliament over public expenditure. To provide for the early presentation

[1] Vide Article 114. See Article 203 in the case of the States.

of the annual estimates, the departments are obliged to compute in the month of November their anticipated expenditure for the ensuing financial year, dating from the coming April. Fallibility must attend calculations which range over sixteen months in advance : too often the estimates do not give a correct picture of the amount actually needed by the departments.

Supplementary grants, thus, fulfil a useful rôle in Parliamentary budgetary practice. They check the executive from increasing the departmental expenditure beyond what was passed at the time of the annual financial grants. Again, the Legislature has the power (i) to assent to the demand ; (ii) to refuse it ; or (iii) to reduce it. The members also have the right to ventilate their grievances against the administration of the government as a whole or, that of a particular department which has put forth the demand for additional grants.

The procedure for passing of supplementary estimates and excess grants is the same as that for demands for grants subject to such adaptations as the Speaker may deem necessary.[1]

Supplementary, Additional, or Excess Grants

A Supplementary Financial Statement shall be laid before both the Houses of Parliament showing the estimated amount of that expenditure for sanction by the House of the People under the following conditions. If during the course of the year (i) the amount authorised by any law made in accordance with the provisions of Article 114 to be expended for a particular service for the current financial year is found to be insufficient for the purposes of that year or when a need has arisen during the current financial year for supplementary or additional expenditure upon some new service not contemplated in the annual financial statement for that year ; or (ii) any money has been spent on any service during a financial year in excess of the amount granted for that service.[2]

The House of the People, however, has been given power to make any grant in advance for meeting unforeseen expenditure for a part of any financial year pending the completion of the procedure prescribed in Article 113 for the voting of such grant and

1 Article 155. For the States see Article 205.
2 Vide Article 115. For the States see Article 205.

the passing of the law in accordance with the provisions of Article 114 in relation to that expenditure. The grant may relate for meeting an unexpected demand upon the resources of India when on account of the magnitude or the indefinite character of the service the demand could not be stated with the details ordinarily given in an annual financial statement. The Parliament, in such cases, shall have power to authorise by law the withdrawal of moneys from the Consolidated Fund of India for the purposes for which the said grants are made.[1]

Borrowing by the Government of India and the States

The executive power of the Union extends to borrowing upon the security of the Consolidated Fund of India. Similarly a State may borrow within the territory of India upon the security of the Consolidated Fund of the State within such limits as may from time to time be fixed by the Legislature of such a State.

The Government of India may, subject to such conditions as may be laid down by or under any law made by Parliament, make loans to any State, and any sums required for the purpose of making such loans shall be charged on the Consolidated Fund of India.

A State may not without the consent of the Government of India raise any loan if there is still outstanding any part of a loan which has been made to the State by the Government of India or by its predecessor Government, or in respect of which a guarantee has been given by the Government of India or by its predecessor Government.

§ 3. *COMPTROLLER AND AUDITOR GENERAL OF INDIA*

The Comptroller and Auditor General has two important function to perform : (1 As Comptroller it is his duty to see that no money is drawn out of the Consolidated Fund without statutory authority; and (ii) as Auditor General of public accounts it is his duty to see that public revenue is spent in accordance with grants as passed by Parliament. The Consti-

[1] Vide Articles 116 and 206 for the States.

tution has provided for the appointment of the Comptroller and Auditor General to perform the above two functions.

Appointment of Comptroller and Auditor General

For the purpose of securing the highest standards of financial integrity of the administration and watching the interest of the taxpayer and also for purposes of Legislative control over the entire executive Government and its officers, the Constitution safeguards the independence and freedom of the Comptroller and Auditor General in a variety of ways. Article 148 of the Constitution provides that the Comptroller and Auditor General of India shall be appointed by the President and shall only be removed from office in like manner and on like grounds as a Judge of the Supreme Court. It also provides that he would not be eligible for any other office either under the Government of India or the Government of any State and that the administrative expenses of his office, including all salaries, allowances and pensions payable to or in respect of persons serving in that office, shall be charged upon the Consolidated Fund of India.

The salary and other conditions of service of the Comptroller and Auditor General shall be such as may be determined by Parliament by law, and until they are so determined, shall be specified in the Second Schedule of the Constitution.[1] These provisions are effective until an Act to determine the salary and other conditions of service of the Comptroller and Auditor General is passed by Parliament. (Article 148 Clause 3). Under sub-paragraph (3) of paragraph 12 of the Second Schedule to the Constitution, the rights in respect of leave of absence and pension and the other conditions of service of the Comptroller and Auditor General shall be governed, or shall continue to be governed, as the case may be, by the provisions which were applicable to the Auditor General of India immediately before the commencement of the Constitution.[2]

1 These provisions are contained in the Audit and Accounts Order, 1936, as adapted by the India (Provisional Constitution) Order, 1947.

2 The Comptroller and Auditor General is the administrative head of the Indian Audit and Accounts Department. His administrative powers will be governed by rules made by the President after consultation with the former, as provided in Clause (5) of Article 148 of the Constitution. He

Duties of the Comptroller and Auditor General

The functions of the Comptroller and Auditor General are derived in the main from the provisions of Article 149 to 151 of the Constitution. Article 149 of the Constitution envisages an Act of Parliament to regulate the duties and powers of the Comptroller and Auditor General in relation to the accounts of the Union and of the States and of any other authority or body and until such a provision is made it lays down that the Comptroller and Auditor General shall perform such duties and exercise such powers in relation to the accounts of the Union and of the States as were conferred on or exercisable by the Auditor General of India immediately before the commencement of the Constitution in relation to the accounts of the Dominion of India and of the Provinces respectively.[1]

The duties and powers of the Comptroller and Auditor General in relation to accounts of the Union and State Governments are laid down in Article 150 of the Constitution and in paragraphs 11, 12 and 15 to 17 of the Audit and Accounts Order, 1936 as adapted by the India (Provisional Constitution) Order, 1947. Article 150 of the Constitution empowers the Comptroller and Auditor General with the approval of the President to prescribe the form in which the accounts of the Union and of the States are to be kept.

It is one of the duties of the Comptroller and Auditor General to prepare each year comprehensive accounts of the receipts and expenditure of each Government, classifying the transactions

derives his financial powers by delegation from the Union Government. His powers, administrative as well as financial, are detailed in the compilation known as the 'Auditor General's Manual of Standing Orders'.

[1] The duties and powers of the Auditor General of India in relation to the accounts of the Dominion of India and of the Provinces immediately before the commencement of the Constitution were prescribed in the Audit and Accounts Order, 1936, as adapted by the India (Provisional Constitution) Order, 1947, and in the Initial Subsidiary Accounts Rules issued by the Governor General in pursuance of paragraph 11 (3) of the former Order. By virtue of the provisions of Article 149 of the Constitution, the relevant provisions of the former Order, continue in force and regulate the duties and powers of the Comptroller and Auditor General in relation to the accounts of the Union and of the States until an Act is passed by Parliament under this Article.

See *An Introduction to Indian Government Accounts and Audit* (Second Edition) 1950. pp. 15-16.

under respective heads and to submit them to the governments concerned. These accounts are designated the Finance Accounts. Besides these accounts, the Comptroller and Auditor General has also to submit annually to each government in respect of accounts kept by him, Appropriation Accounts, that is, accounts relating to expenditure brought into account during a financial year to the several items specified in the Schedules to Appropriation Acts passed in accordance with the provisions of Articles 114 and 204 of the Constitution.

The Comptroller and Auditor General has also to prepare annually for submission to the President a General Financial Statement incorporating a summary of the accounts of the Union and of all the States for the preceding financial year and particulars of their balances and outstanding liabilities and containing such other information regarding their financial position as the President may direct to be included in the Statement.

Duties of the Comptroller and Auditor General in regard to Audit

The duties of the Comptroller and Auditor General in regard to audit are given in paragraph 13 of the Audit and Accounts Order, 1936, as adapted in 1947. The fundamental provisions relating to audit are as follows :—

(1) It shall be the duty of the Auditor General—

(i) to audit all expenditure from the revenues of the Dominion and of the Provinces and to ascertain whether moneys shown in the accounts as having been disbursed were legally available for and applicable to the service or purpose to which they have been applied or charged and whether the expenditure conforms to the authority which governs it.

(ii) to audit all transactions of the Dominion and of the Provinces relating to debt, deposits, sinking funds, advances, suspense accounts and remittance business ;

(iii) to audit all trading, manufacturing and profit and loss accounts and balance sheets kept by order of the Governor General or of the Governor of a Province in any department of the Dominion or of the Province ;

and in each case to report on the expenditure, transactions or accounts so audited by him.

(2) The Auditor General may with the approval of, and shall if so required by, the Governor General or the Governor of any province audit and report on—

(i) the receipts of any department of the Dominion or as the case may be, of the Province ;

(ii) the accounts of stores and stock kept in any office or department of the Dominion or, as the case may be, of the Province.[1]

Audit Reports

Under Article 151 of the Constitution the Comptroller and Auditor General submits the following reports to the Union and States Governments :—

(a) Audit Report on the Appropriation Accounts, and

(b) Audit Report on the Finance Accounts.

He also submits separate reports on the three principal spending departments of the Union—the Defence, the Railway and the Posts and Telegraphs Departments. The transactions of the remaining departments of the Union are dealt with in a single volume. There are separate reports on the Finance Accounts of the States.

The Audit Report on the Appropriation Accounts contains such comments on the regularity and propriety of expenditure as are deemed necessary and proper as a result of audit investigation. It also brings to the notice of the Legislature the results of audit of all trading, manufacturing and profit and loss accounts and balance sheets kept in respect of Government commercial or *quasi*-commercial undertakings. The object of the Audit Report on the Finance Accounts is to present to the Legislature with the accounts of the entire receipts and outgoings of the Govern-

[1] For a more detailed account of the duties and powers of the Comptroller and Auditor General, See *An Introduction to Indian Government Accounts and Audit* (1950) Chapter 3.

The language in Clause (1) of the paragraph of the Audit and Accounts Order, quoted above, follows closely the wording of the Exchequer and Audit Department Act of the United Kingdom.

ment for each financial year a report on the financial results disclosed by the different accounts and other data coming under examination, that is to say, the revenue and capital accounts, and the accounts of the public debt and of the liabilities and assets of the Government concerned as deduced from the balances recorded in the books of the Accounts Office and from other information. It supplements the Audit Report on Appropriation Accounts.

The above Reports relating to the accounts of the Union are submitted to the President who causes them to be laid before the Parliament. The Reports relating to the accounts of the State are submitted to the Governor or Rajpramukh of the State who causes them to be laid before the Legislature of the State.

The procedure which Parliament and the State Legislatures follow in dealing with these Reports is regulated by rules framed by them under Article 118 (1) and 208 (1) of the Constitution. The Audit Report on the Appropriation Accounts and the Audit Report on the Finance Accounts are considered by a committee of the Legislature known as the Committee on Public Accounts.

Functions of the Public Accounts Committee

The functions of the Public Accounts Committee of Parliament as laid down in 'the Rules of Procedure and Conduct of Business in Parliament' are as follows :—[1]

(1) In scrutinising the Appropriation Accounts of the Union Government and the report of the Comptroller and Auditor General thereon, it shall be the duty of the Public Accounts Committee to satisfy itself

(b) that the expenditure conforms to the authority which governs it ; and

(c) that every re-appropriation has been made in accordance with the provisions made in this behalf in the Appropriation Act, or under rules framed by competent authority under the provisions of the said Act :

1 Vide *An Introduction to Indian Government Accounts and Audit* (Second Edition) 1950 p. 117.

(2) It shall also be a duty of the Public Accounts Committee—[1]

(a) to examine such trading, manufacturing and profit and loss accounts and balance sheets, as the President may have required to be prepared, and the Comptroller and Auditor General's Report thereon ; and

(b) to consider the Report of the Comptroller and Auditor General in cases where the President may have required him to conduct an audit of any receipts or to examine the accounts of stores and stock.

[1] The functions of the Committee of Public Accounts of the Provisional Parliament are laid down in Rules 143-4 of the Rules of Procedure and Conduct of Business in Parliament. These rules are as follows :—

"143. Committee on Public Accounts. (1) As soon as may be after the commencement of the first session of Parliament, a committee on Public Accounts shall, subject to the provisions of this rule, be constituted.

(2) The function of the Committee shall be to examine the accounts showing the appropriation of the sums granted by Parliament to meet the expenditure of the Government of India and such other accounts laid before Parliament as the Committee may think fit.

(3) The Committee on Public Accounts shall consist of not more than fifteen members, who shall be elected by Parliament from amongst its members according to the principle of proportional representation by means of the single transferable vote.

(4) The terms of the office of the Committee shall be one year.

(5) Casual vacancies of the Committee shall be filled as soon as possible after they occur by election in the manner aforesaid, and any person elected to fill such vacancy shall hold office for the period for which the person in whose place he is elected would, under the provisions of this rule, have held office.

(6) In order to constitute a meeting of the Committee the quorum shall be four.

(7) (a) The Chairman of the Committee shall be appointed by the Speaker from amongst the members of the Committee. Provided that if the Deputy Speaker is a member of the Committee he shall be appointed Chairman of the Committee.

(b) If the Chairman is for any reason unable to act, the Speaker may similarly appoint another Chairman in his place.

(c) If the Chairman is absent from any meeting, the Committee shall choose another member to act as the Chairman of the meeting.

(8) In the case of an equality of votes on any matter, the Chairman shall have a second or casting vote."

"144. Control of Committee on Public Accounts.—(1) In scrutinising the Appropriation Accounts of the Government of India, and the Report of the Comptroller and Auditor-General thereon, it shall be the duty of the Committee on Public Accounts to satisfy itself—

(a) that the moneys shown in the accounts as having been disbursed were legally available for and applicable to the service or purpose to which they have been applied or charged;

(b) that the expenditure conforms to the authority which governs it; and

The Public Accounts Committee is not an executive body and has no power to disallow any item or to issue an order even on the clearest evidence of extravagance or irregularities. It can only call attention to irregularities and record its findings and recommendations.

The Reports on the Appropriation Accounts and the Finance Accounts are documents of the highest importance and should receive the personal attention of the members of the Legislature. The control which the Legislature will exercise over the Finances of the Government will depend upon the effectiveness of the help rendered by these Reports.

(c) that every re-appropriation has been made in accordance with the provisions made on this behalf in the Appropriation Act, or under rules framed by competent authority under the provisions of the said Act: Provided that the provision made in cl. (c) above shall not apply to any accounts prior to the year 1950-51.

VIII

UNION FINANCES

In order to understand the present structure of federal finance in India and the policy of the Government, and the financial outlook, it is necessary to describe the nature of the Government financial resources and expenditure. Hence the finances of the Government of India and the States are separately analysed to point out the recent changes made therein.

During the period (1939-52) the chief items of revenue and expenditure and their relative importance has changed fundamentally apart from temporary fluctuations due to the War. The financial position and the policy of the Government has been profoundly influenced by the War and the partition of the country. In this chapter the finances of the Government of India will first be considered followed by an examination of the finances of the railways. The effects of the economic policy on the financial resources will be examined with a view to point out the future financial outlook.

§ 1. *FINANCIAL POSITION OF THE GOVERNMENT OF INDIA*

Revenue Account

It is possible to obtain a general idea of the financial position of the Government of India and of the changes in its budgetary position by comparing the overall position of its revenue and, expenditure since 1938-9. Table No. VIII gives total expenditure, expenditure on defence account, civil expenditure and surplus or deficit on revenue account since 1938-9.

No direct comparison can be made between the accounts of the Government of India before 1946-47 with those of the later years as the earlier figures relate to undivided India. However, to illustrate the general trend of financial development the earlier figures are of great significance. The revenue of the Government of India has increased from Rs. 84.47 crores in 1938-

TABLE No. VIII

INDIA'S PUBLIC REVENUE AND EXPENDITURE

(In Crores of Rupees)

Year	REVENUE A—(1) Revenue	(2) Tax Revenue	(3) (2) as percentage of (1)	(4) Non-tax Revenue	EXPENDITURE B—(1) Expenditure	(2) Defence, on Revenue Account (Net)	(3) (2) as percentage of (1)	(4) Civil Expenditure	C—Surplus (+) or Deficit (—)
1938-39	84.47	73.90	87.5	10.57	85.11	46.18	54.3	38.93	—0.64
1939-40	94.57	80.67	85.3	13.90	94.57	49.54	52.4	45.03	—
1940-41	107.65	77.14	71.7	30.51	114.18	73.61	64.5	40.57	—6.53
1941-42	134.56	97.92	72.8	36.65	147.26	103.93	70.6	43.33	—12.70
1942-43	177.09	124.89	70.5	52.20	288.87	214.62	74.3	74.25	—111.78
1943-44	249.96	171.15	68.5	78.80	439.86	358.40	81.5	81.46	—189.90
1944-45	335.70	253.90	75.6	81.81	496.25	395.49	79.7	100.76	—160.55
1945-46	361.19	282.14	78.1	79.05	484.61	360.23	74.3	124.38	—123.43
1946-47	342.89	274.46	80.0	68.43	343.49	207.37	60.4	136.12	—0.60
1947-48	178.77	162.05	90.7	16.72	185.29	86.63	46.8	98.66	—6.52
1948-49	371.70	319.94	86.1	51.76	320.86	146.05	45.5	174.81	+50.84
1949-50	350.39	311.54	88.9	38.85	317.12	148.86	46.9	168.26	+33.27
1950-51	410.66	357.00	86.9	53.66	351.44	164.13	46.7	187.31	+59.22
1951-52	497.67	445.83	89.6	51.84	405.06	181.24	44.7	223.82	+92.61
1952-53	404.98	357.24	88.2	47.74	401.25	197.95	49.3	203.30	+3.73

Figures up to and including 1946-47 relate to undivided India and later figures relate to the Indian Union.

(1) From August 15, 1947 to 31st March, 1948.
(2) Accounts of the Central Government not finalised.
(3) Figures for 1952-53 are Budget Figures.

39 to Rs. 404.98 crores in 1952-53. The growth in revenues in some of the years is as follows :—

(In Crores of Rupees)

Year	Revenue
1938-39	84.47
1948-49	371.70
1949-50	350.39
1950-51	410.66
1951-52	497.67
1952-53	404.98

From the above figures it would appear that the revenue of the Government of India increased from Rs. 84.47 crores in 1938-39 to Rs. 497.67 crores in 1951-52 (revised). The growth in revenues, however, does not give a correct picture of the financial position unless account is taken of the growing expenditure during the period. The corresponding expenditure and surplus or deficit during the above years is as follows :—[1]

(In Crores of Rupees)

Year		Expenditure	Surplus + or Deficit —
1938-39	..	85.11	— 0.64
1948-49	..	320.86	+50.84
1949-50	..	317.12	+33.27
1950-51	..	351.44	+59.22
1951-52	(Revised)	405.06	+92.61
1952-53	..	401.25	+ 3.73

The one broad tendency which is noticeable from the above figures is that whereas the period 1938-39 to 1947-48 was one of deficits, the period 1948-49 to 1952-53 has been one of uninterrupted surpluses.

Capital Account

The above revenue account of the Government of India, however, does not give a complete picture of the financial position unless we take into consideration the capital account of the Government. The following table gives the surplus or deficit in the capital account during the period 1938-39 to 1952-53.

(In Crores of Rupees)

Year	Surplus + Deficit —	Year	Surplus + Deficit —
1938-39	+ 8.05	1946-47	— 56.99
1939-40	+ 3.22	1947-48	— 133.41
1940-41	+ 37.39	1948-49	— 167.48
1941-42	— 25.44	1949-50	— 80.05
1942-43	+ 144.18	1950-51	— 62.04
1943-44	+ 199.54	1951-52	— 96.46
1944-45	+ 437.51	1952-53	- 102.40
1945-46	+ 405.11		

The above table is significant in pointing out that there were huge surpluses in capital account during the years 1942-43, 1943-44, 1944-45 and 1945-46 amounting to Rs. 144.18 crores; Rs. 199.54 crores; Rs. 437.51 crores and Rs. 405.11 crores respectively (these were years of deficits in revenue account). A period of deficits started since 1946-47 and has continued since then; the deficits during 1946-47, 1947-48, 1948-49, 1949-50, 1950-51, 1951-52 and 1952-53 being Rs. 56.99, Rs. 133.41, Rs. 167.48, Rs. 80,05, Rs. 62.04, Rs. 96.46 and Rs. 102.40 crores respectively. The inevitable conclusion is that the surpluses in revenue account have helped to finance a part of capital expenditure. But as the deficits on capital account have been consistently large, there has been a depletion in the cash balances of the Government of India. The overall surplus or deficit position during the period is as follows :—

(In Crores of Rupees)

Year	Surplus + Deficit —	Year	Surplus + Deficit —
1938-39	+ 1.83	1946-47	— 111.58
1939-40	+ 3.48	1947-48	— 110.68
1940-41	— 1.94	1948-49	— 81.67
1941-42	+ 1.29	1949-50	— 43.80
1942-43	+ 2.29	1950-51	+ 12.44
1943-44	+ 65.43	1951-52	— 3.70
1944-45	+ 182.62	1952-53	— 75.60
1945-46	+ 263.25		

The cash balances of the Government of India have also been depleted; the cash balances have been reduced from Rs. 270.30 crores immediately after the partition of the country to Rs. 158.68 crores at the end of March 1952. The opening and closing cash balances of the Government of India since 1938-39 are given in Table IX.

TABLE No. IX

(Crores of Rupees)

1938-39	1939-40	1940-41	1941-42	1942-43	1943-44	1944-45	1945-46
11.31	13.14	16.62	14.68	15.94	18.23	83.66	266.28
13.14	16.62	14.68	15.94	18.23	83.66	266.28	417.95

1946-47	1947-48	1948-49	1949-50	1950-51	1951-52	1952-53
529.53	270.30	273.90	193.28	149.50	161.94	158.68
559.53	159.62	192.23	149.48	161.94	158.24	83.08

Important Heads of Revenue and Expenditure

Having given a broad picture of the trends in the revenue position during the period 1938-52, we pass on to analyse in

greater detail the important heads of revenue and expenditure of the Government of India. Table No. X shows the important heads of revenue and expenditure :—

From the above table it would appear that the revenue from customs has increased from Rs. 40.51 crores in 1938-39 to Rs. 232.00 crores in 1951-52 and Rs. 165.00 crores in 1952-53. There has been a marked increase in the receipts from Union excises from Rs. 8.66 crores to Rs. 86.0 crores. The increase in receipts, however, has been highest in corporation tax where the revenue has increased from Rs. 2.04 crores to Rs. 30.53 crores. The receipts from income-tax have increased from Rs. 15.24 crores to Rs. 124.47 crores. The net contribution of railways to general revenues has increased from Rs. 1.37 crores to Rs. 7.65 crores. It is significant to note that the percentage of income-tax to total tax revenue which had increased from 22.9 per cent in 1938-39 to 50.2 per cent in 1948-49 has again fallen to 38.0 per cent in 1952-53.

Coming to expenditure. The most important single item of expenditure is on defence services; the amount on which has increased from 46.18 crores in 1938-39 to Rs. 197.95 crores in 1952-53. It is interesting to point out that the percentage of defence expenditure to total expenditure ranged from 54.3 per cent to 81.5 per cent during the period; it was highest in 1943-44 when 81.5 per cent of the total tax revenue was spent on defence services only. Even now about half of the revenue is spent on defence services. The expenditure on civil administration has increased from Rs. 10.90 crores to Rs. 55.98 crores in 1952-53. The amount spent on defence services in 1952-53 is Rs. 197.95 crores.[1]

[1] The estimated total disbursements of the Government of India under combined revenue and capital heads in the final budget for 1952-53 amount to Rs. 596.44 crores as against Rs. 662.36 crores in 1951-52 (revised) and Rs. 519.03 crores in 1950-51 (accounts). The overall deficit as reflected in the depletion of the cash balance is placed at Rs. 75.60 crores for 1952-53. The closing cash balance of the Government of India at the end of 1952-53, which, in the interim budget was placed at Rs. 101.89 crores, is now estimated at Rs. 83.08 crores, of which about Rs. 40 crores will be the unspent balance of foreign aid received by Government and kept in the Special Development Fund.

Vide *Report on Currency and Finance, Reserve Bank of India* 1951-52 p 80.

TABLE No. X

(Crores of Rupees)

	1938-39	1949-50	1950-51	1951-52 (Revised)	1952-53 Final Budget (May 1952)
I. Revenue					
Customs	40.51	124.71	157.15	232.00	165.00
Union Excise Duties	8.66	67.85	67.54	84.30	86.00
Corporation Tax	2.04	39.53	40.49	37.55	30.53
(Excess Profits Tax)	..	(3.98)	(3.81)	(1.60)	(1.00)
Taxes on Income other than Corporation Tax	15.24	121.59	132.73	137.45	124.47
(Excess Profits Tax)	..	(3.46)	(2.49)	(1.96)	(3.00)
Currency & Mint	0.58	11.22	12.27	11.31	10.39
(Profits of the Reserve Bank)	(0.20)	(..)	(..)	(8.34)	(7.50)
Net Contribution to General Revenues Railways	1.37	7.00	6.50	7.34	7.65
Posts & Telegraphs	0.19	2.38	3.98	3.87	1.16
Total Tax Revenue	75.40	357.28	404.52	498.53	408.08
Percentage of Taxes on Income to Total Tax Revenue	22.9	45.1	42.8	35.1	38.0
Total Revenue	84.47	350.39	410.66	497.67	404.98
II. Expenditure					
Direct Demands on Revenue	4.24	13.90	12.50	16.95	15.76
Irrigation	0.10	0.08	0.22	0.26	0.18
Debt Services	14.12	39.43	37.36	37.30	36.16
Civil Administration	10.90	39.30	48.80	56.66	55.98
Currency & Mint	0.36	2.08	2.55	2.81	3.20
Civil Works, etc.	2.52	6.53	10.38	13.25	14.96
Miscellaneous	3.63	52.44	52.88	66.44	40.92
Defence Services (Net)	46.18	148.86	164.13	181.24	197.95
Contributions & Miscellaneous Adjustments between Union and States Governments	3.06	2.96	15.59	18.08	20.28
Extraordinary Items	0.01	11.54	7.03	12.07	15.86
Total Expenditure met from Revenue	85.11	317.12	351.44	405.06	401.25
Surplus (+) or Deficit (—)	—0.64	+33.27	+59.22	+92.61	+3.73

Figures for 1938-39 relate to undivided India

§ 2. *DEATH DUTIES*

Having considered the resources and expenditure of the Government of India we pass on to state the case for the levy of death duties which is the most important tax which has not so far been levied in India. An attempt will be made in this section to examine the theory of death duties and the main provisions of the Estate Duty Bill.

The Equity of Death Duties

A tax on the transfer of property from the dead to the living is an important feature in the tax system of almost every democratic State. The tax as a fiscal instrument has been justified from a social as well as from a theoretical point of view. 'Property rights,' observes Professor Pigou, 'are the child of law.'[1] It is universally recognized that as the State protects the property of the individual after his death, it is justified in taking a share of the property before it passes on to the beneficiaries. Gladstone in his speech on succession duties remarked; 'The carrying of property in perfect security over the great barrier which death places between man and man is perhaps the very highest achievement, the most signal proof of the power of the civilized institutions...and an instance so capital of the great benefit conferred by law and civil institutions upon mankind, and of the immense enlargement that comes to natural liberty through the medium of the law, that I conceive nothing more rational than that, if taxes are to be raised at all, the State shall be at liberty to step in and take from him who is thenceforward to enjoy the whole in security that portion which may be *bona fide* necessary for the public purpose.'[2] Hence a statute passed by the State for the curtailment of the right of bequests in respect of the property hitherto enjoyed by the deceased is just.

Apart altogether from the social point of view death duties are theoretically justified on the principles of ability, certainty and convenience. It is now commonly recognized that any single test of ability for purposes of taxation, whether it be amount of income,

[1] Pigou, A.C., *A Study in Public Finance* (Macmillan) p. 7.
[2] *Hansard*, Vol. CXXXII. p. 267 (1853).

or capital, of savings or of expenditure, is bound to have many defects.[1] Hence we have a manifold tax system. Although income is the best single measure of ability, it is not comprehensive. Therefore a different test of ability to pay taxes is needed. Death duties, charged on capital, fill the gap. They provide for an 'important element of ability which an income-tax cannot recognize, except in the most inadequate way.'[2] This may be made clear by an example. Suppose A, B and C each have an income of Rs. 10,000, from earnings, speculative holding of shares, and gilt-edged securities, respectively. Both B and C are enormously better off than A and C is also better off than B. But all of them pay the same amount of income-tax in India. This obviously is unjust. A has nothing but a power of earning; B's income will fluctuate with the money market; C need have no worry with financial uncertainties at all. Income-tax alone, however nicely differentiated, is entirely inadequate to meet the equities of the case. This kind of maladjustment can be substantially removed by death duties. The death duty rates in most countries are progressive, the rates being heavy in the higher ranges of capital.

Moreover, death duties are also a useful supplement to income-tax in another way. The death duties extend (e.g. the English estate duty) to assets such as jewels, pictures, furniture and other goods not producing income; they also tax wealth due to unearned increment in land and other capital transactions.

Thus death duties on the score of ability are justified. Equality in taxation is secured to a greater extent than is possible under income-tax alone.

Death duties are in conformity with Adam Smith's canons of certainty and convenience. The amount which each individual is bound to pay is certain, and not arbitrary. The time of payment, the manner of payment, the quantity to be paid are clear and plain to the contributor, the deceased, and to every other person.[3]

Finally, death duties are most convenient to pay, whether regarded from the point of view of the owner of the property or

[1] See Appendix I.

[2] *Report of the Committee on National Debt and Taxation.* Cmd. 2810 (1927) p. 178. (H.M.S.O.)

[3] Adam Smith, op. cit. pp. 310-11.

the beneficiaries. Death duties are regarded as deferred income-tax, the payment of which has been postponed to the time when the property passes from the deceased to those who inherit it. The guiding principle of every tax system must be to reduce the sacrifice of the taxpayers to a minimum. Assuming a given revenue is to be raised by the Government, the resentment of the taxpayers will be reduced to a minimum if, instead of an additional income-tax exacted during the lifetime of the deceased, the amount is collected through death duties. The time for their collection is most opportune; for the heir who inherits the estate feels no great sacrifice, while the deceased beyond the grave is incapable of feeling the loss.

Objections to Death Duties

Theoretically, death duties are open to two objections. Firstly, their yield is uncertain. Secondly, they cause inequality between one estate and another because they cannot take into consideration the varying frequency of transfer of property. As Dr. Benham puts it : 'A Chancellor of the Exchequer cannot estimate their yield at all accurately for he does not know which rich men will die during the coming year. Over, say, fifty years, one estate may not change hands at all and so may yield nothing in death duties, while another may change hands several times.'[1] Death duties are thus arbitrary in character.

In spite of these objections death duties are found in the tax system of most countries. The reason for their existence (apart from theoretical considerations) is mainly the practical one of plucking the goose with the least squealing.[2] The most favourable time for their collection reduces the sacrifice of the taxpayers to a minimum and hence causes least resentment among them.

Types of Death Duties

Death duties are usually classified under two broad categories: (i) an estate duty (e.g. the English estate duty) levied on the estate as a whole; and (ii) a succession duty (e.g. the English legacy and succession duty) levied on the separate portions going to each beneficiary. The estate duty is usually graduated by reference to the aggregate value of the property passing, without

[1] Benham, *Economics*, p. 306.
[2] Ibid., p. 306.

reference to the interests of the different beneficiaries. In the case of the succession duty the rates are determined solely by the relationship of the beneficiary to the deceased. The succession duty is charged not upon the whole corpus of an estate but upon the interest which a person derives from property left to or devolving on him upon death. The rates are always lower where the beneficiary is the wife, husband or children; they become higher as the relationship of the beneficiaries to the deceased becomes more distant.

Both these types of duties possess some advantages. Simplicity of administration and productivity are the strong features of the estate duty. The succession duty, on the other hand, may be said to be more equitable. Evasion is also less easy under an estate duty than under a succession duty. As the succession duty is based on relationship, the amount of legacy and the wealth of the inheritor, there may be a greater degree of abstract justice in its case. It is, however, advantageous to have both the duties in the tax system. Each will complement the other.

Death duties may be graduated in three ways: (i) the tax may vary with the size of the estate transferred: e.g. the rates are progressive in the case of the English estate duty; (ii) the rates may vary with the relationship of the beneficiaries to the deceased : the English legacy and succession duties are graduated on this principle ; (iii) the rates may vary with the amount inherited by each beneficiary and his wealth: death duties in some of the Continental countries are based on the third form.

Probate Duties in India

In India there are no death duties (*i.e.* estate duty or succession duty). There are, however, certain small duties levied under the Court-fees Act (1870) on probates, letters of administration and succession certificates, which partake to some extent of the nature of the death duties levied in other countries. But the scope of these duties is extremely limited. As the Hindus, Mohammedans, Indian Christians, Europeans, Anglo-Indians, Jews and Parsis are each governed by different laws of inheritance, the application of the duty is different in each case. The duty differs

with race, religion and locality.

The law on Probate Duties is complicated and may briefly be put as follows :

Under section 9 of the Administrator-General's Act (1913), the Administrator-General is required to obtain letters of administration in respect of the property of every person (except those exempted) exceeding the value of Rs. 1,000, if no person entitled to the grant of probate or letters of administration has applied for them. The effect of this provision is that the beneficiaries to the estates of all Europeans, Anglo-Indians, Armenians, Jews, or persons of foreign domicile (dying testate or intestate) are compelled to obtain letters of administration and pay probate duties. Sections 187 and 190 of the Indian Succession Act (1865) necessitate probate or letters of administration only in cases where a right is sought to be established in a court of law. Under section 187, where a will exists no right can be established in a court of law unless probate or letters of administration are obtained. Section 190 demands letters of administration, in the case of intestate succession, prior to the establishment of any claim in a court of law. These sections are not applicable to Mohammedans, Hindus, Buddhists or persons exempted under section 332 of the Indian Succession Act. The Native Christian Administration of Estates Act (VII of 1901) has exempted Indian Christians from section 190. The result of these provisions is that Parsis have to pay probate duties both in the case of testate and intestate succession, while Indian Christians have to obtain letters of administration only in the case of testate succession. Under the Hindu Wills Act of 1870 (as amended by section 154 of the Probate and Administration Act of 1870) Hindus, Sikhs, Buddhists, and Jains who, residing in Bengal and in the towns of Bombay and Madras, desire to establish a claim in a court of law, have to obtain probate and letters of administration in respect of wills and codicils made within these places. If wills and codicils are made outside these areas but relate to immoveable property situated within those areas, probate or letters of administration are necessary. Except in the above cases, unless claims are established in a court of law, the taking of probates

or letters of administration, in the case of Hindus and Mohammedans, is optional.

The Indian Taxation Enquiry Committee sum up the legal position relating to the applicability of the duty in the following paragraph :

The assets in India of Europeans, Anglo-Indians, Armenians, Jews, and persons of foreign domicile must pay duty whether there is a will or not, or whether any right is sought to be established in court or not. The estates of Parsis, whether there is a will or not, and the estates of Indian Christians, where there is a will, must pay duty wherever the estate be situated in India, though only when a right is sought to be established in the courts. The estates of Hindus, where there is a will made in, or relating to, immoveable property situated in the Lower Provinces of Bengal or the cities of Bombay or Madras, must also pay duty, but only again when a right is sought to be established in the courts. The estates of all Mohammedans who die testate or intestate, the estates of all Hindus and Indian Christians who die intestate, and the estates of all Hindus who die leaving wills not falling within the scope of the Hindu Wills Act need pay no duty, unless the parties themselves apply for and obtain probate or letters of administration.[1]

The effect of all the legislation is that as probate, letters of administration, and succession certificates are taken only by a small section of the population of India, the burden of the tax is not fairly distributed among the various communities.

Hindus and Mohammedans, who generally do not make wills, are obviously escaping the burden of taxation. The burden of taxation is heaviest on Europeans and persons of foreign domicile. The yield from probate duties is necessarily low.

Mitakshara and Dayabhaga Law

Another difficulty in the imposition of death duties in India is the Hindu law of inheritance. The two schools of Hindu law —the Mitakshara and Dayabhaga—differ in regard to the laws of inheritance. According to the Mitakshara law (which is in force outside Bengal) each son upon his birth takes an interest equal to that of his father in ancestral property, whether it is moveable or immoveable. 'On the death of the father the son

[1] *Report of the Taxation Committee*, 1924-25, p. 268.

takes the property, not as his heir, but by *survivorship*.[1] The coparceners in a Hindu joint family do not own property as individuals. Hence a Hindu joint family is a corporate body 'having a continuous existence notwithstanding the death of individual members'.[2]

Under Dayabhaga law, the sons do not take any interest in ancestral property in the lifetime of their father. Their rights rise for the first time on the father's death. In short, under Mitakshara law the sons acquire an interest by birth; in Dayabhaga law they acquire an interest with the father's death. The result of the above distinction is that the interest of the coparceners under Mitakshara law fluctuates with the birth or death of other coparceners. Hence the imposition of death duties is a matter of difficulty in the case of Hindu joint families governed by the Mitakshara school of law.

Results of the Differences in Laws

From the above legal summary three important consequences follow. *First,* the choice of the methods of taxation is limited. Any inheritance tax in India (on account of the Mitakshara school of law) which is based on the separate inherited share of each recipient rather than on the whole estate is not possible for India. Hence the application of the principle of progression, based on the windfall element arising out of the degree of relationship of the heir to the deceased, cannot be applied in taxing the estate. The English legacy and succession duties are therefore ruled out.

Secondly, the discrimination in taxation of an estate according to the age of the estate is also not possible. It has often been suggested that in taxing estates graduation according to the time element should be introduced. Thus the older the estate the higher should be the rate of the tax on that portion; *i.e.* taxation should be according to the number of times the estate has already changed hands. Since inheritance under Mitakshara law is by *survivorship* discrimination in taxation according to the age of the estate is also ruled out.

Thirdly, the English estate duty, which taxes the whole estate

[1] Mulla, D. F., *Principles of Hindu Law* (Eastern Law House, Calcutta) 1936, p. 323.

[2] Trevelyan, Sir E. J., *Hindu Law as administered in British India* (Thacker Spink) 1929, p. 213.

(rather than the shares which pass to each beneficiary), appears to be most suitable to Indian conditions.

History of Estate Duty

The Estate Duty Bill is not a new measure. For the first time in 1925, a measure of this kind was recommended by the Taxation Enquiry Committee. Its recommendation, however, could not be given effect to on account of the impending constitutional changes beginning with the appointment of the Statutory Commission in 1928 and ending with the passing of the Government of India Act in 1935.

The need for the imposition of an estate duty began to be felt again during World War II which helped many people in acquiring enormous private fortunes. Imposition of such a duty, on the analogy of the duty existing in Britain, could not be undertaken under the Government of India Act, 1935. Accordingly, in 1944 the Act was amended to confer on the Central Legislature power to levy an estate duty in respect of property other than agricultural land, the latter falling within the ambit of the Provincial List.

In 1946 a Bill, seeking to levy a duty on estates 'passing' or 'deemed to pass' on the death of a person, was introduced in the Central Legislature but for various reasons, however, it could not be taken up for consideration. The Bill was reintroduced in the provisional Parliament in 1948 and, although it passed through the select committee stage, it could not be taken up for consideration and with the dissolution of the provisional Parliament, it lapsed.

Under the Constitution of India, as in the original Government of India Act, duty on agricultural land falls within the Legislative List of the States, while non-agricultural property comes within the ambit of the Centre. However, to secure uniformity of levy, several states, namely, Bombay, U.P., Orissa, Madhya Pradesh, Hyderabad and Rajasthan, have passed the necessary resolutions under Article 252 of the Constitution authorizing the Centre to legislate on their behalf in respect of agricultural property situated in these states.

Under the Bill, the duty realized in respect of agricultural land situated in a State will be assigned to the State. As regards

the net proceeds on non-agricultural property the same will, under Article 269 of the Constitution, be assigned to the States on such principles of distribution as Parliament may formulate.

Main Features of the Estate Duty Bill

Having described the theory of death duties and their present position in India, we now pass on to consider the main features of the Estate Duty Bill, 1952. The salient features of the Bill may categorically be summarised as follows :—

1. *Levy of Estate Duty.* In the case of every person dying after the commencement of this Act, there shall be levied and paid upon the principal value of all property, settled or not settled, including agricultural land situate in the States of Bombay, Orissa, Uttar Pradesh, Hyderabad, Rajasthan and Madhya Pradesh a duty called estate duty at the rates fixed in accordance with Annual Finance Acts.

2. *Property within Disposing Capacity.* Property which the deceased was at the time of his death competent to dispose of shall be deemed to pass on his death.

3. *Gifts mortis causa.* Property taken as a gift made in contemplation of death shall be deemed to pass on the donor's death.

4. *Gifts within a certain period before death.* Property taken under a disposition made by the deceased purporting to operate as an immediate gift *inter vivos* whether by way of transfer, delivery, declaration of trust, settlement upon person in succession, or otherwise, which shall not have been *bona fide* made two years or more before the death of the deceased, shall be deemed to pass on the death.

Provided that in the case of gifts made for public charitable purposes the period shall be six months.

5. *Policies kept up for a donee.* Money received under a policy of insurance effected by any person on his life, where the policy is wholly kept up by him for the benefit of a donee, whether nominee or assignee, or a part of such money is in proportion to the premiums paid by him, where the policy is partially kept up by him for such benefit, shall be deemed to pass on the death of the assured.

6. *Annuity or other interest purchased or provided by the deceased.* Any annuity or other interest, including moneys payable under a policy of life assurance, purchased or provided by the deceased, either by himself alone or in concert or by arrangement with any other person shall be deemed to pass on his death to the extent of the beneficial interest accruing or arising, by *survivorship* or otherwise, on his death.

7. *Foreign property.* There shall not be included in the property passing on the death of the deceased :—

(*a*) immoveable property situated outside the territories to which this Act extends or immoveable property consisting of agricultural land situated in any State other than the States specified in the Schedule to this Act;

(*b*) moveable property situated outside the territories to which this Act extends at the time of the death unless in the case of any property, whether settled or not, the deceased was domiciled in the said territories at the time of his death.

8. *Agreement for avoidance or relief of double taxation with respect to estate duty.* The Central Government may enter into an agreement with the Government of any reciprocating country for the avoidance or relief of double taxation with respect to estate duty leviable under this Act and under the corresponding law in force in the reciprocating country.

9. *Allowance for quick succession to land or a business.* Where the Board is satisfied that estate duty has become payable on any property consisting of land or on a business (not being a business carried on by a company) or any interest in such land or business passing upon the death of any person, and that subsequently within five years estate duty has again become payable on the same property or any part thereof passing on the death of the person to whom the property passed on the first death, the amount of estate duty payable on the second death in respect of the property so passing shall be reduced as follows :—

Where the second death occurs within one year of the first death, by 50 per cent;

Where the second death occurs within two years of the first death, by 40 per cent;

Where the second death occurs within three years of the first death, by 30 per cent;

Where the second death occurs within four years of the first death, by 20 per cent;

Where the second death occurs within five years of the first death by 10 per cent;

Provided that where the value on which the duty is payable of the property on the second death exceeds the value on which the duty was payable of the property on the first death, the latter value shall be substituted for the former for the purpose of calculating the amount of duty on which the reduction under this section is to be calculated.

10. *Rates of duty to be according to the Central Act.* The rates of estate duty shall be according to such scale as may be fixed by an Act of Parliament.

11. *Principal value how to be estimated.* The principal value of any property shall be estimated to be the price which, in the opinion of the Controller it would fetch if sold in the open market at the time of the deceased's death.

12. *Reasonable funeral expenses and, with some exceptions, debts and incumbrances to be allowed for in determining chargeable value of estate.* In determining the value of an estate for the purpose of estate duty, allowance shall be made for reasonable funeral expenses and for debts and incumbrances; but an allowance shall not be made :—

(*a*) for debts incurred by the deceased, or incumbrances created by a disposition made by the deceased, unless, subject to the provisions of section 26, such debts or incumbrances were incurred or created *bone fide* for full consideration in money or money's worth wholly for the deceased's own use and benefit and take effect out of his interest, or

(*b*) for any debt in respect whereof there is a right to reimbursement from any other estate or person, unless such reimbursement cannot be obtained, or

(*c*) more than once for the same debt or incumbrance charged upon different portions of the estate,

And any debt or incumbrances for which an allowance is

made shall be deducted from the value of the property liable thereto.

13. *Method of collection of duty.* Estate duty may be collected by such means and in such manner as the Board may prescribe.

14. *Payment of duty may be accepted in prescribed Government Securities.* The Board may prescribe that Government securities shall be accepted in payment of estate duty on such terms as it thinks fit.

15. *Persons accountable, and their duties and liabilities.* Where any property passes on the death of the deceased :—

(*a*) every legal representative to whom such property so passes for any beneficial interest in possession or in whom any interest in the property so passing is at any time vested,

(*b*) every trustee, guardian, committee or other person in whom any interest in the property so passing or the management thereof is at any time vested, and

(*c*) every person in whom any interest in the property so passing is vested in possession by alienation or other derivative title, shall be accountable for the whole of the estate duty on the property passing on the death.

(*d*) every person accountable for estate duty under the above provisions shall, within six months of the death of the deceased or such later time as the Controller may allow deliver to the Controller and verify to the best of his knowledge and belief, an account of all the property in respect of which estate duty is payable.

16. *Penalty for default.* Any person who without reasonable cause has failed to comply with the provisions of section 50 or section 51 or has failed to comply with the said provisions within the time allowed, shall be liable to pay a penalty of one thousand rupees or a sum equal to double the amount of estate duty, if any remaining unpaid for which he is accountable, according as the Controller may direct :

Provided that the Controller may reduce the penalty in any particular case.

17. *Appeal against determination by Controller.* Any person objecting to the valuation made or the estate duty deter-

mined by the Controller or denying his liability to account for the duty payable in respect of any property, may within ninety days of the receipt of the notice of demand under section 54, appeal to the Board in the prescribed form and verified in the prescribed manner.

18. *Statement of cause by the Board to High Court.* Within ninety days of the date upon which he is served with an order under sub-section (3) of section 57, the person accountable may present an application to the Board in the prescribed form, accompanied by a fee of five hundred rupees, requiring the Board to refer to the High Court any question of law arising out of such order and the Board shall, if in its opinion a question of law arises out of such order, state the case for the opinion of the High Court.

The Indian Estate Duty Bill is based on the English Estate Duty Act. The success of the Act will depend upon the administrative machinery which would implement its provisions. Perhaps the greatest difficulty in its administration will be the problem of evasion. Fiscal evasion is often regarded a virtue—the avoidance of taxes within the bound of law is a part of private morals and business ethics. "The man who can show us how to avoid our taxes and still keep within the limits of the law is looked upon as a public benefactor." Fiscal evasion is, more or less, common in every country. It is easy and common in direct taxes. In inheritance taxes even under a highly efficient tax-collecting system, there is always a complaint that evasion is inconceivably great. It is difficult to estimate the degree of evasion. Nevertheless, it is a matter of common experience that men of reputed great wealth do leave a tax-paying estate of very moderate size while their children live in prosperity. So inefficient was the tax-collecting machinery in America at one time that a premium was placed on evasion and the honest man was branded as a fool. Hence it is highly desirable that tax administrators and legislators must see that evasion is least in our country.

§ 3. *RAILWAY FINANCE*

The history of railway finance is an oft-told tale, but must briefly be summarized here if we are to understand to what extent railways would be contributing towards the general finances of the Government of India.

The financial position of the railways was fully examined and reported upon by the Ackworth Committee in 1921. The question of separating the railway finance from the general Budget was discussed in the Legislative Assembly in 1924. After considerable opposition a compromise was reached in the so-called 'Convention' of 1924 which determined the annual contribution of the railways to the Central Budget. In 1925-26 the railway Budget was for the first time separated from the general Budget.

Under the terms of the railway Convention the Central Exchequer was entitled to receive from the railways a sum equal to 1 per cent of the capital-at-charge in the penultimate year plus one-fifth of the surplus profits in that year. This was the fixed contribution from the railways. If after payment of this fixed contribution, the amount available for transfer to the railway reserves exceeded Rs. 3 crores, one-third of that excess amount was to be paid to the general Budget.

This Convention, as modified in 1943, continued till 1949 when, as a result of the recommendations of the Railway Convention Committee, the Constituent Assembly on December 21st 1949 passed a Revised Railway Convention to determine the future share of the railways to the general Budget.

The Railway Convention Committee made the following recommendations, which form the present basis of the relationship between General and Railway Finance :—

(1) The present relationship between General and Railway Finance should be altered to give the Government of India the status of sole shareholder in the Railway undertaking and General Finance should be guaranteed, for a period of five years from 1950-51, a fixed dividend at 4 per cent on the loan capital invested as computed annually. This arrangement should be reviewed towards the close of the five-year period.

(2) The annual contribution to the Depreciation Fund should be a minimum of Rs. 15 crores for the five-year period and the full cost of replacement should be charged to this fund.

(3) A Development Fund should be constituted from the surpluses of prosperous years, the existing Betterment Fund being merged with it. The Development Fund will provide for passenger amenities on a scale commensurate with the status of

the undertaking and for labour welfare and will finance projects which may be necessary but unremunerative to begin with. The scope of the Revenue Reserve Fund, which would replace the Railway Fund, should be limited to ensure payment of the fixed dividend to General Revenues and to finance any deficit in the railway budget.

(4) With the integration of the States Railways with the Indian Government Railways, two separate accounts—a loan account and a block account—should be maintained. The loan account will represent the share capital of the railways, while the block account will represent the physical assets of the railways whether financed from loan capital or revenue.

The above arrangement has not only assured to the general revenues a definite return on capital-at-charge thus facilitating forward economic planning in the civil field, but at the same time will afford an opportunity to the railways to build up adequate reserves in years of prosperity to ensure a minimum return to General revenues in years of depression.

Railway Revenues

An important feature of the post-partition railway finances has been the continuous rise in gross traffic receipts from Rs. 210.10 crores in 1948-49 to Rs. 282.16 crores in 1952-53. Working expenses have also shown a rise but at a relatively slower pace with the result that net traffic receipts have shown an increase from Rs. 39.78 crores in 1948-49 to Rs. 64.23 in 1952-53. Capital-at-charge has increased from Rs. 667.43 crores in 1947-48 to Rs. 862.16 crores in 1952-53. The surplus has increased from Rs. 19.98 crores in 1948-49 to Rs. 23.47 crores in 1952-53. A more detailed picture of railway finances may be seen at a glance from Table XI.[1]

Future of Railway Finance

The budgetary position of Indian railways in future would be much more favourable than it has been in the past. One of

[1] It is difficult and risky to compare the early railway figures with the figures after the partition of the country as the early figures include accounts for the railway-lines now in (i) Pakistan; (ii) ex-India State Railways and (iii) Burma Railways. Hence I have given the figures of railway finances for the past six years. 1947-48 to 1952-53. The figures for 1947-48 are from August 15, 1947 to March 31, 1948.

the most important factors affecting the budgetary position is the grouping of the different railway systems of the country into one co-ordinated undertaking, consisting of six major zonal administrations. This programme of integration is expected to achieve uniformity in administration and financial control, besides helping in the completion of the scheme of rationalisation and readjustment of the rates and fare structure.

The Railway Administration has also undertaken measures to speed up the developmental projects, particularly for the manufacture of locomotives. The Government factory at Chittaranjan has already commenced production from November 1950. The Tata Locomotive and Engineering Co. Ltd. (to which the Government have subscribed Rs. 2 crores as share capital) has also gone into production. When these works are in full production it is expected that the railways would attain self-sufficiency in their annual requirements of locomotive boilers and spare parts.

TABLE XI

(Lakhs of Rupees)

	1948-49	1949-50	1950-51	1951-52	1952-53
1. Contribution to General Revenues	7,34	7,00	32,51	33,35	34,00
2. Surplus or Deficit	19,98	14,59	15,05	22,06	23,47
3. Transfer to Revenue Reserve Fund	—	—	5,05	12,06	11,47
4. Transfer to Development Fund	84	—	10,00	10,00	12,00
5. Ratio of Working Expenses to Gross Earnings	79.8	81.7	80.7	79.0	77.6
6. Ratio of Net Profit to Capital-at-charge	2.8	2.0	2.8	2.6	2.7
7. Percentage of Net Traffic Receipts to Capital-at-charge	5.7	5.6	6.4	7.3	7.4

[1] From 1950-51 data for ex-India State Railways have been included.

[2] Known as Railway Reserve Fund till the end of 1949-50.

[3] As from 1950-51, a Railway Development Fund was set up in which was merged the Betterment Fund.

[4] Amount paid as Divided to General Revenues at 4 per cent on Capital-at-charge in lieu of interest charges and the *ad hoc* contributions to General Revenues (as per revised Railway Convention (1949).

Finally, the budgetary position would also be affected by: (1) the prospects of a rise in industrial and agricultural production; (2) the improvement in haulage capacities on certain lines; (3) the increase in coal freight; and (4) the freight rate adjustments already made or proposed to be made during 1952-53.

As a result of the working of the above factors it is safe to infer that not only the railways would contribute handsomely to the General finances of the country but they would also reduce their rates of expenses and put their house in order. There can be no doubt that they would certainly be credited with the lion's share in the future promotion of India's economic progress.

§ 4. *DRAFT FIVE-YEAR PLAN*[1]

From the above brief summary of expenditure of the Government of India it will appear that the larger part of development expenditure is from capital account.[2] Meanwhile it was felt that in order to bring about a speedy rise in the economic and social development of the country it was necessary to assess the material, capital and human resources of the country.[3] The Planning Commission was appointed in March 1950 and charged with the immediate task to formulate a plan for the most effective and balanced utilization of the country's resources. The Commission issued its Report in July 1951.

The Plan consists of two parts, involving a total outlay of Rs. 1,793 crores on development mainly in the public sector over the period 1951-52—1955-56. The first part of the Plan envisages an expenditure of Rs. 1,493 crores to be raised mainly

1 Since the work went to the press the Final Report of the Five-Year Plan has been published. See Appendix 4 for an account of the Final Report on First-Year Plan.

2 Developmental heads include, in the main, irrigation, electricity schemes, civil works, scientific departments, education, medical and public health, agriculture, rural development, veterinary, co-operation, industries, and civil aviation.

3 The basic principle underlying the development expenditure is to accelerate the pace of development without accentuating inflationary pressure or putting a severe strain on the economy of the country. With this end in view fiscal and monetary policies have been co-ordinated in order to give effect to the maximum possible mobilisation of domestic capital resources. The Reserve Bank of India, to check further inflation, adopted three types of measures (1) the Bank rate was raised (2) the open market policy was revised and (3) an attempt was made to introduce credit elasticity in the money market by developing a bill market.

from internal resources. The second part will depend on the availablity of external assistance. The following figures show the distribution of expenditure in the first part of the Plan.

	Outlay (1951-56) (crores of rupees)	Percentage of total outlay (1051-56)
Agriculture and Rural Development ...	191.70	12.8
Irrigation and Power	450.36	30.2
Transport and Communications ...	388.12	26.1
Industry	100.99	6.7
Social Services	254.22	17.0
Rehabilitation	79.00	5.3
Miscellaneous	28.54	1.9
	1,492.93	1000.0

Agriculture takes the pride of place in the Plan, which together with irrigation and power accounts for 43 per cent of the expenditure. The Commission's proposals are to produce 7.2 million tons of additional food, 2.1 million bales of jute, 1.2 million bales of cotton, 0.375 millions tons of oil seeds and 0.69 million tons of sugar. To place agriculture free from the vagaries of the monsoon the plan has allotted Rs. 450 crores for irrigation and power projects which are calculated to irrigate an additional area of 8.8 millions acres and raise the production of power by 1.1 million kilowatt, representing an increase of 20 per cent in the country's irrigated area and of 70 per cent in its power potential.

The Plan allocates Rs. 101.0 crores or 6.7 per cent of the total expenditure on development of industries. Industrial development in India, the Plan points out, has to be based on the existence side by side of a public and private sector ; private enterprise has an essential rôle to play in the expansion of industry, as a part of the scheme of national planning. Nationalisation on a large scale is ruled out by the Commission. The increased industrial production is expected to raise the annual production of mill cloth to Rs. 4,500 million yards and of hand-loom to 1,900 million yards ; the output of jute manufactures is estimated to rise by about 25 per cent of its present level ; of steel from 1.0 million tons to 1.3 million ton and of cement from 2.6 million tons to 406 million tons.

With the launching of the Five-Year Plan in 1951-52 the Central Government, railways, Part A and Part B States incurred the following expenditure for the implementation of the Plan :—

(Crores of Rupees)

		1951-52 (Revised)	1952-53 (Budget)
1. Central	... ...	142	175
2. Railways	... ...	77	79
3. Part A States			
(i) Revenue Account	...	38	39
(ii) Capital Account	...	92	119
4. Part B States			
(i) Revenue Account	...	9	10
(ii) Capital Account	...	24	23
Total	...	382	445

It may be pointed out that for the public sector the available resources of the Government of India and the States fell short of the requirements and therefore a part of the expenditure had to be financed partly by drawing on cash balances. The situation was easier for the Central Government in 1951-52 on account of exceptionally high receipts, which reached the peak figure of Rs. 497-67 crores (revised). In 1952-53 the resources estimated for developmental expenditure are smaller than in 1951-52, as the revenue receipts for 1952-53 are estimated at only Rs. 404.98 crores and many of the State Governments have not yet taken further measures to augment their resources.

External Assistance and Planning

Besides, it has been realized that for the full implementation of the development programme of the Five-Year Plan foreign assistance is necessary. The revised version of the Plan involves an outlay of Rs. 2,234 in the public sector as compared to the outlay of Rs. 1,793 crores in the Draft Five-Year Plan. The domestic resources available, as estimated in the Colombo Plan Report, are put at Rs. 1,551 (over the period of six years 1951-57 over which the developmental expenditure of the plan is now projected) leaving a gap of Rs. 783 crores to be covered by foreign assistance.[1] Thus foreign aid will form an important

[1] These figures are based upon the *Colombo Plan for Co-operative Economic Development in South and South-East Asia,* March 1952, pp. 23-24.

part for putting through the Revised Five-Year Plan. India has already received grants from the U.S.A., Australia, Canada and New Zealand amounting to Rs. 128 crores. The following table gives details of foreign assistance during the past two years :—

(Millions of U. S. Dollars)

	Date of Agreement	Amount of Loan on Aid
I. Loans and Aid from U.S.A. Government		
(i) Technical Aid under Point Four Programme	1950	1.20
(ii) Wheat Loan—June	1951	190.00
(iii) Aid under Mutual Security Agreement—January	1952	50.00
II. Aid Under Colombo Plan Agreement		
(i) From Canada	1951	14.15
(ii) From Australia	1951	9.36
(iii) From New Zealand	1951	0.69
III. Other Aid From the Ford Foundation—January	1952	3.00
		268.40
IV. Proceeds of Loans From IBRD	1950	18.50

The huge developmental expenditure envisaged by the Five-Year Plan depends upon external finance, (Rs. 783 crores) releases from sterling balances, an import surplus of the order of 1,173 crores, (over the six-year period covered by the Colombo Plan) and private annual average investment of Rs. 255 crores. In the absence of reliable data about internal finance, dependent upon savings, it is difficult to say whether the targets envisaged by the Plan can be achieved without much strain on the economy of the country. Be as it may, the fact remains that unless the development expenditure of the magnitude as envisaged by the Plan takes place, there seems to be little prospect for any permanent growth of public revenues and expenditure. The future of the Central and States finances is most intimately bound up with the increased production, agricultural and industrial, upon which alone a sound budgetary policy can be framed in India.

IX

STATE FINANCES

I. FINANCES OF PART A STATES

In this chapter an attempt will be made to analyse the finances of the States during the period 1939-53. The finances of Part A States will be described in the beginning followed by an account of the finances of Part B States. It may be pointed out that no account of the budgets of the Part B States prior to 1949-50 is available and hence no comparison in their budgetary position with the pre-war year 1938-39 is possible.

§1. *BUDGETARY POSITION*

Trends in Revenue and Expenditure

Table No. XII shows the consolidated position of Part A States regarding their revenue, expenditure, surplus or deficit and gross debt since 1938-39 :—

It will appear from the above table that the revenue of Part A States increased from Rs. 84.74 crores in 1938-39 to Rs. 314.82 crores in 1952-53 (Interim Budget). The expenditure has similarly increased from Rs. 85.76 crores in 1938-39 to Rs. 323.32 crores in 1952-53. It is significant to point out that an era of surplus budgets started from 1939-40 and has continued till 1951-52 (revised budget). There has not been one single year of deficit all through the past eleven years. (The State Budgets stand in contrast with the Central Budgets during the period 1939-40 to 1947-48 which were years of heavy deficits in the Government of India's finances). The debt of all Part A States has increased from Rs. 163.20 crores in 1938-39 to Rs. 330.12 crores in 1951-52.[1]

[1] On account of the General elections two budgets were presented for 1952-53 by the States Governments—an Interim Budget (February) and a Final Budget (May). The figures given in this chapter are those of the Interim Budget.

TABLE No. XII

(In Crores of Rupees)

	Part A States			
Year	(1) Revenue	(2) Expenditure met from revenue	(3) Surplus (+) or Deficit (—)	(4) Debt Position (Gross Total Debt)
1938-39	84.74	85.76	— 1.02	163.20
1939-40	90.83	89.22	+ 1.61	167.61
1940-41	97.48	95.18	+ 2.30	169.91
1941-42	107.41	103.48	+ 3.93	169.15
1942-43	124.31	118.18	+ 6.13	170.26
1943-44	163.31	153.85	+ 9.46	196.28
1944-45	208.18	204.28	+ 3.90	174.35
1945-46	229.33	218.14	+ 11.19	162.97
1946-47	238.80	230.09	+ 8.71	157.79
1947-48	202.77	194.19	+ 8.58	118.14
1948-49	258.21	250.82	+ 7.39	142.92
1949-50	291.31	287.29	+ 4.02	186.24
1950-51	294.32	293.14	+ 1.18	245.86
1951-52	316.89	316.39	+ 0.50	330.12
1952-53	314.82	323.32	—8.50	..

The major heads of tax revenue of the States are : (1) Taxes on Income ; (2) Land Revenue ; (3) Sales Tax ; (4) Excise and (5) Stamps. An analysis of the distribution of tax revenue of some of the heads is necessary for a broad picture of the trends of State finances during the period 1938-39 to 1952-53.

Distribution of Revenue

The following table shows the distribution of tax revenue under the above heads since 1948-49 :—

(Crores of Rupees)

	1938-39	1948-49	1949-50	1950-51	1951-52 Revised	1952-53 Budget
Taxes on Income	1.50	41.79	45.74	46.97	52.31	50.48
Land Revenue	25.41	25.78	29.06	33.21	33.91	41.74
Sales Tax	...	32.95	46.30	51.34	47.74	45.67
Excise	13.08	34.32	29.03	27.04	26.28	26.07
Stamps	9.59	16.31	17.32	19.22	20.19	20.19

The above table is interesting in pointing out the remarkable change in the distribution of tax revenue in State finances since 1938-39. The State's share of income-tax has increased from Rs. 1.50 crores in 1938-39 to Rs. 50.48 crores in 1952-53 ; it now forms the largest single source of State revenues (*i.e.* 22.51 per cent). The receipts from land revenue have increased from Rs. 25.41 crores to Rs. 41.74 crores. Perhaps the most remarkable change in State finances has been the phenomenal growth of revenue from sales tax which did not exist at all as a source of State revenues in 1938-39. The revenue from sales tax reached the peak point in 1950-51 and the receipts have since then been reduced. As a result of the passing of the Essential Goods Act the receipts would further be reduced in future. The revenue from excise has increased from Rs. 13.08 crores in 1938-39 to 26.07 crores in 1952-53. Finally, the receipts from stamps have increased from 9.59 crores in 1938-39 to Rs. 20.19 crores in 1952-53. A somewhat detailed account of the sources of revenues is given in the following pages.

§2. *TAXES ON INCOME*

The distribution of income-tax among the Provinces till 1947-48 was governed by the Niemeyer Award under the terms of which the Provinces received 50 per cent of the receipts from taxes on income apart from corporation tax; taxes on emoluments of

officers serving under the Central Government and taxes attributable to the centrally administered areas. After the partition of the country the provincial share of income-tax was regulated by the Government of India (Distribution of Revenues) Order, 1948 promulgated on the 17th March, 1948. Under the Order the percentage of income-tax allocated to the Provinces is as follows:—Madras 18, Bombay 21, West Bengal 12, United Provinces 19, East Punjab 5, Bihar 13, Central Provinces and Berar 6, Assam 3 and Orissa 3.

In November 1949 the Government of India invited Mr. Chintaman D. Deshmukh to give an Award determining the distribution of income-tax between the Centre and the States and the share of the States *inter se*. The Award which was made at the close of January 1950, will remain in force pending the recommendations of the Finance Commission. The Deshmukh Award is restricted to Part A States. The field of inquiry of Mr. Deshmukh was a very limited one; it confined itself to a re-allocation of the percentages of income-tax released by the partition. The Award refrained from any comprehensive redistribution of the States' share *de novo*. The percentage to be distributed was 14.5 units out of 100 which comprised the lapsed share of Bengal 7.5, Punjab 4, Sind 2 and N.W.F. 1. The allocation by Mr. Deshmukh is largely based on population with some weightage in favour of the weaker States. Minor adjustments were made for rounding off the figures to the nearest ½ per cent. The shares of the States under the Deshmukh Award, the Niemeyer Award, and the *ad hoc* arrangement made by the Government of India after the partition are given in the following table :—

(Figures are in percentages)

States	Niemeyer Formula	*Ad Hoc* arrangement after the partition	Deshmukh Award
Madras ...	... 15	18	17.5
Bombay ...	... 20	21	21
West Bengal	... 20 (Bengal)	12	13.5
Uttar Pradesh (U. P.)	... 15	19	18
Punjab (Undivided)	... 8	5	5.5
Bihar ...	... 10	13	12.5
Madhya Pradesh (C. P.)	... 5	6	6
Assam ...	... 2	3	3
Orissa ...	... 2	3	3

The table below shows the distribution of income-tax among the States since 1938-39.

(In Crores of Rupees)

Year		Income Tax	Year	Income Tax
1938-39	...	1.50	1946-47	29.87
1939-40	...	2.79	1947-48	29.74
1940-41	...	4.16	1948-49	41-79
1941-42	...	7.39	1949-50	45.74
1942-43	...	10.90	1950-51	46.97
1943-44	...	19.50	1951-52	52.31
1944-45	...	26.56	1952-53	50.48
1945-46	...	28.75		

The figures in the above table are significant in pointing out that the State share of income-tax has increased from Rs. 1.50 crores in 1938-39 to Rs. 50.48 crores in 1952-53. It now forms the biggest single source of revenue of Part A States. Its actual allocation among the States *inter se* would be determined by the recommendations of the Finance Commission.[1]

§3. *LAND REVENUE*

Introductory

Indian land policy during the past few years has undergone revolutionary changes. The two most important changes to which attention may be drawn are :—(i) Abolition of the Permanent Settlement; and (ii) Abolition of zamindari. A brief account of the land laws passed by some of the State Governments will be given in the following pages. In order to appreciate the necessity for the land reforms a knowledge of land policy as it developed through British rule is necessary. I shall, therefore, briefly describe the important features of the land revenue system at the close of British rule. It may, however, be pointed out that in some of the States the old revenue system still prevails.

No one item of revenue in India has aroused greater interest and criticism than the revenue derived from land. But studies on agrarian problems and policies have been surcharged with political controversies and have not taken into consideration the more important economic issues. A dispassionate examination of the subject, while pointing out the defects of the land revenue policy, should also acknowledge the abuses of tenant law which have invariably enhanced the burden of the peasantry. It is thus

[1] See Appendix 5 for the main recommendations of the Finance Commission.

that we can get a clear picture of the existing conditions of the peasantry and suggest remedies for an equitable distribution of the tax burden among the different sections of the agricultural classes.

The answer to the old controversy whether land revenue is a tax or rent depends upon the answer to the question whether the State or the landlord is the full proprietor of the soil—a subject which in itself is a matter of endless controversy.[1] The discussion is a profitless war of words,[2] and as Dr. Anstey has observed, the answer would not suffice either to defend or condemn the system.[3] For whether the Government or the landlord is the full proprietor of the soil, any attempt to rackrent the peasantry would produce the same unfortunate results on them. Hence a proper and a scientific study of the subject must consider the relative burden of land revenue on the peasantry under the permanent and temporary settlements, and zamindari and ryotwari settlements.

With the abolition of zamindari in some of the States this phase of the controversy has entirely changed. But if the peasant will be rackrented under State ownership recent land reforms would stand self-condemned.

In studying the problems of land revenue in India it would be imprudent to generalize, for the principles and basis of land tax differ in different parts of the country. In some parts of the country Permanent Settlement still prevails ; in others land revenue is subject to periodical revision. Again, in West Bengal and some of the other zamindari tracts, there are numerous intermediaries between the Government and the cultivator, while in the ryotwari areas of Bombay and Madras the cultivator deals direct with the Government. In Bihar and the U.P. the peasant would also now directly deal with the Government. Thus in examining the burden of land revenue in India we should always take into consideration the systems of land tenure, the type of settlement and the tenancy legislation of the State.

1 *The Indian Taxation Enquiry Committee* (1924-5) were unable to record a unanimous and definite finding on the vexed question whether the land revenue is a tax or rent. They, however, rightly remarked, since land revenue forms a deduction from national dividend, it should be taken into consideration in dealing with the question of the incidence of taxation on the country as a whole (Report, pp. 66-7).

2 Baden-Powell, B. H., *Land Revenue in British India* (1913) p. 49.

3 Anstey, op. cit., p. 375.

A Tax in rem

An examination of the burden of land revenue between the different sections of agricultural classes leads us to consider the defects of land revenue. Land tax in India is based either on gross produce, or net produce, or economic rent or the actual rent paid by the cultivating classes.[1]

The basis of the taxation of land, has gradually undergone a change. Formerly the land tax was a definite part of the estimated gross produce. Though the expenses of cultivation varied considerably for raising the same amount of produce, yet the same percentage, two-thirds or one-fourth, as the case might be, was demanded from each cultivator. Hence the ability of the individual taxpayer, as judged by the productive powers of the soil, was not taken into consideration in fixing the tax.[2]

The basis of assessment is now net assets and not gross produce. The substitution of net instead of gross produce, marked a 'step forward in the evolution of the idea of ability to pay'.[3] In ascertaining net assets the productive capacity of the soil, climate, agricultural conditions, and irrigation facilities among other factors, are always taken into consideration. The practice of course varies enormously from State to State. Assessment based on net assets always takes into consideration the varying expenses of cultivation.

But the one defect of an assessment based on net assets is that it regards land revenue as a tax *in personam*. Taxation of the net product, says Professor Seligman, looked at the produce of the source of industry, rather than at the recipient of the earnings; it was a tax on things, rather than on persons; it was abstracted from the personal situation of the taxpayer.[4]

[1] *The Indian Taxation Enquiry Committee*, with reference to the basis of assessment, sum up the position thus: 'Except in British Baluchistan, the land revenue has ceased to represent a portion of the gross produce. In the United Provinces, the Punjab, and the Central Provinces, the Government demand is theoretically based on an economic rent, but actually takes many other factors into consideration. In the case of Madras and Burma, the assessment is based on the net produce, *i.e.* the gross produce minus the cost of cultivation. In Bombay, the rate of assessment is arrived at empirically with reference to the general economic consideration. *Report.*, p. 66.

[2] For an excellent account of the modern principles of assessment under British rule. See Sir Edward Blunt, *The I.C.S.* (1937) ch. viii.

[3] Seligman, op. cit., p. 14.

[4] Ibid.

The modern tendency has been to substitute taxes *in personam* for taxes *in rem*. It is now commonly recognized that taxes are ultimately paid by persons and not things. Inanimate objects like land, tea, sugar, etc., are incapable of paying taxes. The ultimate burden of taxing such objects must fall upon persons. This fundamental change of attitude to lay greater emphasis on human personality is clearly reflected in different tax systems. The adoption of the principle of progression; the differentiation between earned and unearned incomes; and the differential consumption taxes on necessaries and luxuries, are some of the devices to introduce a greater personal element in the tax system of a country.

The Indian land revenue system for more than a century has failed to view the land tax from this changed angle of vision. The result has been that land revenue viewed as a system of taxation is not only not progressive, but actually tends in the opposite direction. Since it is levied at a flat rate, it often is a regressive tax. It created vast inequalities of tax burdens. At one extreme are the big zamindars who contributed a nominal part of their income, lawfully or unlawfully derived from the cultivators; at the other end of the scale come the cultivators of uneconomic holdings who were impoverished under the heavy burden of rent and the illegal exactions of the zamindars.

The one conclusion from the above observations is that reforms in land policy should lay greater emphasis on the human personality of the peasant. Land revenue is a direct tax and, as in other direct taxes, it should be possible to introduce some element of differentiation through various devices.

Illegal Exactions

Another important defect of the land policy all through the period is that it did not provide adequate protection to the peasantry through the land laws with the result that the burden of rent on the tenants was increased. Enough importance is seldom given to this defect of the land policy. An examination of the condition of the peasantry in landlord-ridden provinces will convince any fair-minded inquirer that their impoverished condition was to a large extent due to rackrenting (through various illegal devices) by the zamindars and the chain of inferior proprietors.

With the conferment of definite legal rights by the British the economic status of the zamindar underwent a remarkable change. He lost touch with the actual cultivators and became an absentee landlord. Absentee landlordism gave rise to a host of intermediaries, varying in number, in different parts of the country. Such middlemen exploited the weak economic position of the actual tillers of the soil by lowering their legal status *i.e.* reducing them to the position of non-occupancy tenants. Through the practice of *nazaranas* or *awabs*, zamindars or intermediaries extorted large sums of money from the peasantry, annually or on the renewal of a tenancy. Mr. Jack, in his report on the settlement operations in Bakarganj, estimated that in one year the total amount collected as *awab* in that district amounted to no less than 20 lakhs of rupees, or more than the entire Government land revenue and one-quarter of the entire rentals of the district. The practice was, more or less, common in other provinces ; thus the stronger the position of the zamindar the larger was the amount extorted by him.

The levy of such illegal exactions had considerably increased the tax burden of the peasantry, though in the majority of cases the information did not see the light of day. Nor must it be forgotten that the burden of such illegal exactions was always heavy on ordinary tenants who were already paying higher rents than stable tenants. Thus the weaker the legal position of the tenant, the greater was the chance of his exploitation by the zamindars.

Abolition of Permanent Settlement

One of the most important problems of land revenue which had created inter-provincial inequalities and unfair distribution of tax burdens is that of the Permanent Settlement. The history of the Permanent Settlement is an oft-told tale and need not be repeated here. It was one of the most important defects of the land revenue system introduced by the British rule. It thoroughly crippled the finances of Bengal, Bihar and Orissa. It resulted in a colossal loss of revenue to the Government. Above all it created an unfair distribution of tax burdens between zamindars and ryots and other classes of society. Unfortunately the greatest mistake

in the terms of the Permanent Settlement was that while the revenue demand was taken to be fixed, the rents of the ryots were left at the mercy of competitive forces.

The abolition of the Permanent Settlement by the State of Bihar has been one of the major achievements of the Government. In its abolition there is no question of breach of faith, for after the lapse of a century and a quarter the original contract based on loyalty in troublous times had lost much of its value.

The abolition of the Permanent Settlement would rehabilitate State finances, distribute equitably tax burdens between different sections of the peasantry and make land revenue a fairly elastic source of revenue.

The glaring injustice of the Permanent Settlement to the people of other States is apparent from the following table:—

(In Lakhs of Rupees)

States	Total Revenue 1952-53	Land Revenue 1952-53	Percentage of Land Revenue to total Revenue
Assam ...	10,05	1,65	16.42
Bihar ...	31,43	1,59	5.1
Bombay ...	61,54	6.30	10.24
Madhya Pradesh	20,74	4.56	22.0
Madras ...	63,90	7,78	12.2
Orissa ...	11,78	1,07	9.1
Punjab ...	16,92	1,95	11.5
Uttar Pradesh ...	62,55	14,77	23.6
West Bengal ...	35,91	2,07	5.8

It is clear from the above table that the income from land revenue in Bengal and Bihar, in spite of high fertility, comparative immunity from famine conditions, and the cultivation of money crops like jute and rice, is far less than that in other States. The result has been, that the Permanent Settlement in Bengal and Bihar, while benefiting the small minority of zamindars in the States, necessitated imposition of heavier tax burdens.

Abolition of Zamindari

Perhaps the most outstanding achievement of the Congress Government is the abolition of zamindari, particularly in the States

of Bihar and Uttar Pradesh. In Bihar with the abolition of zamindari the Permanent Settlement has also come to an end. The State of Bihar had to undergo unusual difficulties in passing zamindari abolition legislation as some of its acts were declared *ultra vires* by courts of law. The Bihar Land Reforms Act is the final act of the State Government under which zamindari has been abolished in the State. The important provisions of the Act may briefly be summarized as follows:—

The Bihar Land Reforms Act provides that the State Government may issue a notification, under Clause 3 (1), in respect of estates and tenures falling within a particular income group, and on the publication of the notification, the estate or tenure will vest in the State Government, together with all lands and buildings appertaining thereto. The homestead lands of the landlords, together with the land in their *khas* cultivation and buildings used as *golas*, factories or mills, will, however, be left in their possession. No institution, religious or secular, or any trust or any building connected therewith will be taken charge of by the State and there will be no interference with the right of any trustee to apply the trust money to the object of the trust.

The Act provides payment of compensation to the landlords whose estates and tenures will be taken over by the Government. Assessment of compensation will be made after calculating the gross assets and the net annual income of the proprietor. The amount of compensation will be a certain multiple, varying from 3 to 20 times, of the net income. To the amount thus determined, 50 per cent of the arrear rent, which is not time-barred, will be added. An appeal against the order of the Compensation Officer shall lie to a Judge of the High Court. Provision has also been made for payment of *ad interim* compensation from 2½ per cent to 3 per cent on the estimated amount of compensation till the date of final payment. The compensation will be made either in cash or in bonds or partly in bonds.

One of the most important provisions of the Act is regarding the collection of rents through *Panchayats*. The *Gram Panchayats* may also be entrusted with the management of the estates and tenures, including trees, forests, fisheries, *jalkars,* hats, bazars, and ferries, comprising such estates.

Finally, the Act provides for the appointment of a Land Commission, which will be consulted by the State Government in administering the system of land-tenure in the State.[1]

Conclusions

Having considered some of the important features of the land revenue system, in conclusion some general observations may be made to show that the revenue system which fitted in with the economic and political tendencies of the British rule is not in harmony with the present economic situation.

Historically, the land revenue system as it exists today is a product of political forces. Its evolution has closely followed the power which the landlords or peasants wielded in the body politic of the country. Thus throughout the British rule the landlords had the upper hand in shaping land policy as the foreign rulers had to court their sympathy. The Congress Government has to depend upon the will of the people. This change in the complexion of the Government is essentially responsible for the abolition of the zamindari and land reforms.

The first half of the nineteenth century was a period of conquest and consolidation of British power. The main object of the East India Company was the realization of a large amount of revenue necessary for the wars in which the Company was engaged. There was little opportunity in such a disturbed period to base the land revenue system on sound theoretical principles. During the second half of the nineteenth century, with the development of means of transportation and communication, the economic unification of the country had begun. It was in this period that all the work of survey and settlement was completed and the land revenue demand was placed on principles which, even today with slight modifications, form the basis of land assessment. Lord Curzon's famous Resolution of 1902 is a landmark in the history of land revenue policy.[2] It was an emphatic assertion of the suc-

1 Under the U. P. zamindari abolition Act the State has taken over the zamindari. The zamindaris will be paid compensation according to rates prescribed in the Act.

The working of both these Acts is being watched with keen interest.

2 *Government Resolution (East India) on Land Revenue.* Cmd. 1089 (1902). Government Press, Calcutta.

cess of the land revenue policy. However, it did not advocate any fundamental change in principles of assessment.

With the rise and establishment of British rule a very important change appeared in the fiscal system of the country. Under Moghul rule the policy of tax-exemptions was a part of the political and fiscal system of the country. In return for political support the nobility was freed from tax payments. With the consolidation of the British power these political privileges were abolished. The abolition of these privileges marked the emergence of two important principles of taxation : *the universality and the uniformity of taxation.*

The first principle means that no person who has an income from land may escape taxation; the second, that all those who enjoy similar economic privileges from land should be subjected to the same fiscal treatment. Proportional taxation, which taxes wealth objectively, that is, it taxes 'objects' and not 'persons', was the most convenient way to put these principles in the land policy of the country. Herein lies the origin of treating land revenue as a tax *in rem.*

It should not be inferred that this feature of land taxation was peculiar to India. Before the French Revolution the French nobility was exempt from the payment of land taxes and the greater burden of taxation was on the poor peasantry. With the emergence of the third estate after the French Revolution, in proportional taxation the poor and middle classes found a weapon to transfer the tax burden to the wealthier classes. Proportional taxation is eminently suited to abolish class privileges. It was this objective, non-personal character of the proportional system, observed Professor De Viti, that led to its being carried into effect by the men of the Revolution, who wished, above all else, to protect themselves against the danger of a return to those privileges.[1]

The land policy of the British rule, however, now needs a revision under changed economic conditions. Proportional taxation with its objective basis is not in harmony with the changed economic policy. The recent agricultural policy of the Govern-

[1] De Viti, op. cit., p. 7.

ment, especially in the field of irrigation, scientific research and co-operation, has resulted in a new outlook with regard to the duty of the Government towards the cultivators. The aim of tenancy legislation throughout India has been to lighten the burden of the peasants and to save them from the vexatious exactions of the landlords. But all these measures, good in themselves, have merely patched the old machine of the nineteenth century. For neither scientific agriculture nor co-operation can improve the condition of the peasantry unless rental burdens are more equitably distributed between different classes of the peasants.

The abolition of zamindari demands an orientation in land policy which should, among others, bring the land revenue system in harmony with the rest of the tax system of the country. Such a change in policy would rehabilitate the finances of the country and remove the oft-quoted accusation that the cultivators are groaning under the heavy weight of rental payments. India is not overtaxed in comparison with other countries. The defect of the land revenue and rental system lies, not in its pressure of total taxation, but in its maldistributed tax burdens. Nor should it be forgotten that 'more important than the reduction of taxation or of the land revenue is the need to extend protection against rack-rents.'[1] Finally, the abolition of zamindari will not bring about an economic millenium in the country unless the economic condition of the teeming millions is improved. The success or failure of the Government land policy depends upon the efficient management of zamindari.

§4. *SALES TAX*

Sales Tax, which was first introduced in Madras, to make good the loss in revenue resulting from prohibition, is now levied in all the States. The rate, as well as the basis of the tax differs from State to State. Unlike the British Purchase Tax, it is realized, in most cases, from the consumers at the retail stage. In some States it is a single point tax; in others it is levied at more than

[1] Anstey, op. cit., p. 177.

one stage.[1] A brief description of the Bihar Sales Tax will bring out its important features; these features are, more or less, common in most of the States.

The Bihar Sales Tax Act, 1944, was first introduced in October, 1944. Under this Act, tax was levied from dealers whose gross turnover exceeded Rs. 5,000 during the preceding financial year, and the general rate of tax was 3 pies in the rupee, on the taxable turnover. This Act was replaced by the Bihar Sales Tax Act, 1947, with effect from the 1st July, 1947, when the taxable quantum was raised from Rs. 5,000 to Rs. 10,000; but the rate of tax continued to remain at 3 pies in the rupee. From the 1st October, 1948, the general rate of tax was increased to 6 pies in the rupee, and a higher rate of tax at 9 pies was fixed for luxury goods, and a lower rate of 3 pies on essential commodities like coal, cotton, cloth, etc. Till the beginning of 1949, foodgrains were exempted from the levy of the Bihar Sales Tax; but in order to find finance for increased expenditure foodgrains were also brought within the ambit of the tax, and became leviable to tax at 3 pies in the rupee with effect from the 1st April 1949. The same rates of tax continue at present.

[1] The existing rates of sales tax in some of the States are as follows :—

In West Bengal the general rate of tax is 9 pies per rupee. Certain goods are exempt from levy of sales tax. The list of exempted goods in Bengal appears to be a bit liberal.

In the U.P. the general rate of tax is 3 pies per rupee but tax is realized at each stage of transaction. On certain goods the tax is realised at the rate of 6 pies, the tax being realised at the last stage of transaction only. Certain goods are exempt from levy of sales tax. The list of exempted goods appears to be liberal.

In Madhya Pradesh the general rate of the tax is six pies per rupee. The rate of sales tax on luxury goods is one anna per rupee but bullion and specie is taxed at the rate of 3 pies per rupee. Certain goods are exempt from levy of sales tax. The list of such goods appears to be a bit liberal.

In Assam the general rate is 6 pies per rupee. Luxury goods are taxed at the rate of 1 anna per rupee. Certain articles are exempt from payment of sales tax.

In Orissa the general rate of tax is 9 pies in the rupee. Luxury goods are taxed at 1 anna in the rupee.

The revenue from sales tax during 1938-39, 1948-49, 1949-50, 1950-51, 1951-52 and 1952-53 in each of the States is shown in the following table :

(Lakhs of Rupees)

States		1938-39[1]	1948-49	1949-50	1950-51	1951-52	1952-53
Assam	...	—	24	49	56	71	57
Bihar	...	—	2,33	2,58	4.41	3,50	3,10
Bombay	...	—	6,76	13,23	15,18	12,37	11,47
Madhya Pradesh	...	—	1,43	1,99	2.35	1,97	1,70
Madras	...	—	13,03	15,24	15,85	16,25	16,00
Orissa	...	—	30	62	80	85	85
Punjab	...	—	27	1,39	1,78	1.64	1,58
Uttar Pradesh	...	—	4,27	6,12	5.21	4,95	4.90
West Bengal	...	—	4,32	4,64	5,20	5,50	5,50

Sales Tax and Article 286 of the Constitution

The administration of sales tax has been presenting problems of unusual difficulty. Article 286 of the Constitution which governs the levy of sales tax has been variously interpreted by the States and Centre. The Article runs as follows :

(1) No law of a State shall impose, or authorise the imposition of, a tax on the sale or purchase of goods where such sale or purchase takes place.

(a) outside the State ; or

(b) in the course of the import of the goods into, or export of the goods out of, the territory of India.

(2) Except in so far as Parliament may by law otherwise provide, no law of a State shall impose, or authorise the imposition of, a tax on the sale or purchase of any goods where such sale or purchase takes place in the course of inter-state trade or commerce.[1]

The Centre has been interpreting the Article to maintain freedom of inter-state trade and commerce and to retain intact its exclusive power of levying import and export duties. The States, on the other hand, were levying a sales tax on the goods sold within the States but exported later on to areas outside the State. This practice is not only in violation of the inter-state commerce clause of the Constitution but also resulted in duplication of tax burdens on through trade. Meanwhile in a case which went to the Supreme Court from Travancore-Cochin High Court

[1] In 1938-39 there was no sales tax.

[1] For the purposes of sub-clause (a), a sale or purchase shall be deemed to have taken place in the State in which the goods have actually been delivered as a direct result of such sale or purchase for the purpose of consumption in that State, notwithstanding the fact that under the general law relating to the sale of goods the property in the goods has by reason of such sale or purchase passed in another State.

the Supreme Court unanimiously agreed with the judgment of the Travancore-Cochin High Court quashing sales tax assessments on the turnover of sales of the export commodities, coir products, lemon-grass oil, and tea.

The judgment of the Supreme Court has created a situation which would force the States and the Centre to consider *de novo* the Sales Tax Acts in all the States.[1]

Perhaps the best tentative solution out of the embarrassing situation may be that under the inter-state commerce clause the following arrangement may be made between the Government of India and the State :

(a) Where sale and physical delivery to an individual buyer are in the same State, there is no inter-state commerce and the State where the sale and physical delivery take place will tax.

(b) Where, as a direct result of a sale by a dealer in State A, goods are despatched to State B there is inter-state trade ; neither State A nor State B can tax that transaction under the Constitution though State B can tax through subsequent sales of that article in that State. The Centre, however, should examine the feasibility of promoting legislation to ensure that sales tax is not thus evaded by the dealers or consumers in certain categories of goods like motor-cars, refrigerators, radios, etc.

In the long run, however, it is necessary, in the interest of freedom of inter-state trade and commerce and uniform incidence of tax burden on trade and commerce, to pass an all-India law on Sales Tax the administration of which may be entrusted to the States. The law may incorporate some of the salient features of the British Purchase Tax.

[1] Three Travancore-Cochin firms dealing with export sales of the above commodities had claimed exemption from Sales Tax before the State High Court on the ground that the sales took place 'in the course of the export of goods out of the territory of India' within the meaning of Article 286 (1) (b) of the Constitution. The Sales Tax authorities rejected this contention on the ground that the sales were completed before the goods were shipped and could not, therefore, be considered to have taken place in the course of the export trade. The High Court upheld the claim of exemption whereupon the State made an appeal to the Supreme Court. The Supreme Court upheld the judgment of the Travancore-Cochin High Court.

§5. *EXCISE*

Introductory

Another important source of State revenue is excise. By 'excise' [1] is ordinarily meant a tax or duty on commodities produced within the country, which in India consists of taxes on gasoline, alcoholic beverages, sugar, matches, cloth, tobacco etc. etc. It also includes the revenue derived from a licence to conduct certain trades, such as those of tobacconists, brewers, distillers, etc.

In India excise duties fall into two classes: (i) those that are levied for the purpose of revenue, and (ii) those that are levied for the purpose of restricting the consumption of commodities such as intoxicants and harmful drugs.

Taxes of the former class are, from the economic and fiscal point of view, the necessary corollary of import duties. Restrictive excises, though primarily meant to check consumption, bring a large amount of revenue as well.

The principal excises falling in the first category are the duties on sugar, matches, cloth and tobacco. The revenues from restrictive excises include the proceeds of duties on the sale and manufacture of 'country spirit' (spirit locally made in imitation of foreign liquor), hemp and drugs and opium.

Under the Constitution the State Governments are authorised to levy;

> Duties of excise on the following goods manufactured or produced in the State and countervailing duties at the same or lower rates on similar goods manufactured or produced elsewhere in India:—
>
> (a) alcoholic liquors for human consumption;
>
> (b) opium, Indian hemp and other narcotic drugs and narcotics; but not including medicinal and toilet preparations containing alcohol or any substance included in sub-paragraph ([illegible]f entry 51 of the seventh schedule.

Lessons from American Experience

In examining the principles of the liquor excise policy of a government two views are commonly met with: those which advocate total prohibition, and secondly those which support modified prohibition so that the licensed vendor may not be replaced by illicit distillers and smugglers.

[1] 'The word "excise" has no definite meaning in the terminology of taxation.' Lutz, H. L., *Public Finance* (Appleton) 1936, p. 567.

The answer to the question, Is prohibition possible? depends upon the question, What would be the cost? The prohibition problem should be studied primarily from the standpoint of administration, because the success or failure of prohibition depends upon the efficiency of administration.

A study of liquor-control administration in the United States during the period when the Eighteenth Amendment was in force has shown that the enforcement of prohibition is an impossibility.[1] Although the Eighteenth Amendment became law it was a dead letter.[2] The action taken by the Congress in controlling liquor consumption was quite inadequate. Vast amounts of illicit liquor were produced as a result of the prohibitive excises, and the consequent high prices gave the bootlegger an excellent opportunity to make exceptionally high profits.

During the pre-prohibition period the illicit manufacture of liquor was secretly carried on. In the prohibition period 'the technique and the financial resources of big business enterprise were applied in the illicit production and sale of liquor.'[2] The evils of incomplete enforcement during the 'dry period' left legacies even after the repeal. 'The bootlegger is still with us,' observed Professor Studenski in *The National Municipal Review*.[3] Bootlegging has become so deep-rooted in American life that thousands of persons find in bottlegging a profitable occupation and are not prepared to leave it. Bootlegging has become a regular business. . 'Repeal has materially diminished bootlegging, but it has not eliminated it altogether.'[4]

[1] The Eightee[illegible] Amendment came into force from January 17, 1920. Under it the ma[illegible]re, sale, import, export or transportation in intoxicants was forbid[illegible] 'Intoxicating liquors' were those which contained alcohol in excess o[illegible] per cent. The Repeal Amendment Proclamation was issued by the President on December 5, 1933.

[2] See Catlin, G. E. G., *Liquor Control* (Home University Library), pp. 135-46.

The per capita consumption of alcohol has been greater under prohibition than during the war period, with high taxation and restricted production and sale, Warburton Clark, *The Economic Results of Prohibition* (Columbia University Press) 1932, p. 260.

[3] Studenski, P., *Liquor Taxes and the Bootlegger. Supplement to the National Municipal Review*, vol. XXIV, January, 1935, p. 63.

[4] Studenski, op. cit., p. 66.

The one conclusion which the American experience suggests is that 'prohibition is impossible by fiat except in communities where it has overwhelming popular support as a public policy. Excessive excises do not promote temperance but tempt the bootlegger, and thus the very object of prohibition is defeated.

The moral from the American experience is to discover methods which may be less drastic than prohibition in theory but giving better results in practice. Perhaps the best way to achieve such results is to tax the liquor trade with moderation and to educate public opinion against liquor consumption. Such a policy, it would seem, is a compromise between the protagonists of prohibition and the believers in the doctrine of individual liberty who do not want any law for prohibition.

To achieve the most wholesome results both the methods should work side by side. For the one without the other would not produce the desired results.

To promote temperance, moderation in taxation should be accompanied by: (i) limitation of hours during which intoxicating liquor can be sold; (ii) reduction in the number of shops; (iii) restrictions in quantity for sale both 'on licence' and 'off licence'; (iv) discriminating taxation of the stronger liquors; (v) curtailment of attractions ordinarily provided in liquor shops; and (vi) educating public opinion against liquor consumption.

The enlightenment of the masses, especially the backward classes (among whom the drink habit is very strong), through propaganda and education, is one of the most essential requisites for the promotion of temperance. Social legislation, however well framed and prohibitive in character, would be impotent as breaches of the law easily escape detection.[1] It is upon the bed-rock of a sound public opinion that the success of a temperance movement rests. Any attempt to force immediate restrictions would not banish the saloon but would result in disastrous conse-

1 The attempt to increase sobriety by means of a law which makes for more objectionable habits of drinking and destroys public morality, is obviously futile. Prohibition is no longer a child of yesterday. Its results can be perceived by all who have eyes to see. These results are such that the only possible conclusion is: the sooner we get rid of prohibition the better. *Report of the Official Prohibition Enquiry of 1923* (Finland), pp. 149-50. Quoted in the *Prohibition Experiment in Finland* by Joh. H. Wuorinen (Columbia University Press) 1931, p. 94.

quences to public morality and the tax policy of the country. The experience of other countries suggests rather strongly that education and propaganda, working by conviction and persuasion, are perhaps no less effective than legislative compulsion in the attainment of prohibition.[1]

The Congress Prohibition Programme

With the inauguration of Provincial autonomy the Congress Governments in the Provinces had followed a policy of prohibition. The prohibition programme had created a new range of problems in Provincial finance in 1939-40. The Provincial Governments had introduced in the budgets for 1939-40, (i) employment tax; (ii) enhanced duty on petrol; (iii) sales tax and (iv) a provincial rate on urban areas to make up the loss of revenue through excise. But as the period of the Congress Government's administration was a very short one the policy of prohibition could not be implemented.

After the independence of the country a fresh impetus has been given to the policy of prohibition and the States of Madras and Bombay have completely gone dry. The State of Uttar Pradesh has introduced prohibition in some of its areas. Madras introduced prohibition and by October 1948 the entire State went dry. Complete prohibition was introduced in Bombay on the 6th April, 1950. For financial reasons the State of Uttar Pradesh, however, has decided not to extend the area of prohibition for the present. Prohibition reduced State excise revenue in 1949-50 by Rs. 5.71 crores; the loss for Madras and Bombay being Rs. 3.41 crores and Rs. 1.41 crores respectively. In 1950-51 receipts from excise had further been reduced by Rs. 4 crores as compared with 1949-50 and stood at Rs. 25 crores. Meanwhile the Planning Commission has suggested the appointment of a high-power committee to review the working of prohibition in the States. The Planning Commission's interest in prohibition lies mainly in its financial implications. The Commission has come to the conclusion that the whole experiment should be reviewed in the light of the experience gained. Only after such an examination will the decision

[1] Wuorinen, *The Prohibition Exjeriment in Finland* (Columbia University Press) 1931, p. 237.

be taken how the Directive Principles of State policy regarding prohibition should be implemented. It is likely that prohibition may not be further introduced in other States and Madras and Bombay may gradually become wet again.

The revenue from excise in some of the years as compared with 1938-39 is given in the following table :—

(Lakhs of Rupees)

		1938-39	1948-49	1949-50	1950-51	1951-52	1952-53
Assam	...	35	95	88	93	81	76
Bihar	...	1,20	4,85	4,99	5,26	5,34	5,80
Bombay	...	2,90	6,17	4,09	1,07	85	1,07
Madhya Pradesh	...	64	2,19	2,24	2,31	2,23	2,23
Madras	...	3,72	3,67	59	55	39	34
Orissa	...	33	1,36	1,82	2,13	1,92	1,67
Punjab	...	1,02	2,38	2,32	2,08	2,39	2,16
U. P.	...	1,33	6,53	5,96	6,51	6,16	6,12
West Bengal	...	1,59	6,22	6,14	6,20	6,19	5,92
Total	...	13,09	34,32	29,03	27,04	26,28	26,07

Conclusions

A policy of immediate total prohibition is the cherished ambition of many social reformers and politicians in India. Such a policy, however, justifiable it may be from religious, social or other points of view, is not within the scope of practical finance. In the present financial condition of the States, when larger revenues are required to develop the nation-building departments, it is impracticable to sacrifice this source of revenue. The deficit so caused cannot be easily made up either by the substitution of another tax or group of taxes.

Secondly, prohibition, besides stopping the revenue, would require additional heavy expenditure for its enforcement.[1] Moreover, the cost of prohibition is bound to increase the more vigorous is the policy for its enforcement. Finally, anything like real prohibition in India, where every palm tree, in addition to the *mahua* plant, is a ready source of alcohol, would require a standing army. Hence a policy of prohibition, on the score of expense and difficulty of enforcement, is not possible for India.

My own conclusion expressed with all diffidence is that India can hardly afford to go dry at the present stage of its

[1] *The Indian Taxation Enquiry Committee* put down 18 per cent of the tax revenues of the country as the probable cost of prohibition.

economic development when it needs huge resources for its nation-building activities. Prohibition is a luxury to India. Besides, it will not improve the moral tone of the people for whom it is meant. It is perhaps a conscience easing process for the protagonists of prohibition. Madras and Bombay have already crippled their finances through a policy of prohibition. The sooner this policy comes to an end the better it is for the country as a whole as in a federal system of finance the revenues of the country are indivisible.

§6. *MISCELLANEOUS TAXES*

Among the miscellaneous taxes a tax on agricultural income, a tax on motor spirit, an entertainment tax and a duty on electricity may be mentioned. These taxes are levied by most of the State Governments. A description of the important features of these taxes, as levied of the State of Bihar, is given in the following pages. These features are, more or less, common in the tax laws of all the States.

Agricultural Income Tax

The most important gap in the financial arrangements in the Reforms period (1919-37) was the exemption of agricultural income from income-tax. Some of the State Governments have, however, passed Acts to tax agricultural incomes since 1939.

Land in most countries is subject to four different taxes :

(i) A flat rate on capital or annual value ;
(ii) An income-tax on incomes derived from land ;
(iii) A death duty ; and
(iv) Local rates.

In India land till 1939 was subject to only two taxes (i) Land Revenue and (ii) Local rates (cesses). In permanently settled areas land was very lightly taxed. Under temporary settlements there was a progressive reduction in the percentage of land revenue to net assets. In the beginning the landlords were given only a small portion of the rents collected by them, *i.e.* not more than 10 per cent. Regulation VII of 1822 fixed the State share at 83 per cent and Regulation IX of 1833 at 66 per cent of rental values, while the Saharanpur Rules of 1855 reduced it to 50 per cent. The percentage was reduced further in the United Provinces

where the amount that may be taken as land revenue was limited to not less than 30 and not more than 40 per cent of the net assets of the land.

The levy of an agricultural income-tax has removed an important defect in the tax structure of State Governments.

The Bihar Agricultural Income-Tax Act

The Bihar Agricultural Income Tax Act, 1938, came into force from 1938. Under this Act assessees whose total agricultural income exceeded Rs. 5,000 were required to pay Agricultural Income Tax at a sliding scale of rate varying between 6 pies to 30 pies in a rupee on their net income. This Act was replaced by the Agricultural Income Tax Act, 1948 with effect from the beginning of the year 1948-49, when the taxable limit was reduced from Rs. 5,000 to Rs. 3,500 a year, and a progressive rate of tax varying between 9 pies and 4 annas was fixed. From the beginning of 1949-50, the taxable limit was further lowered to Rs. 3,000, and a provision was also made for the charging of a super-tax from persons whose net income exceeds Rs. 25,000. The rate of super-tax varies from one anna to five annas three pies in the rupee, depending on the total agricultural income of an assessee. The rate of tax is now fixed from year to year through the Bihar Finance Act.

The Bihar Entertainment Duty Act

The Bihar Entertainment Duty Act, 1937, was enacted in 1937. Under this Act, the rate of tax depended on the amount of admission fee and the amount of tax varied between 6 pies and one rupee. Under the Bihar Entertainment Tax Act, 1948, which came into force with effect from the 1st October, 1948, the rate of tax was fixed at 25 per cent of the admission fee, plus another 25 per cent as surcharge. Entertainment tax is thus being charged from 1st October 1948 at 33 per cent of the total face value of the ticket (including tax). The same rate of tax is in force during 1952-53.

The Bihar Motor Spirit (Taxation on Sales) Act

The rate of tax up to the 31st March, 1948 was one anna six pies per imperial gallon. From the 1st April, 1948, the rate of tax was increased to 4 annas per imperial gallon. It has further been increased to 5 annas per gallon from the 1st April,

1949. This rate continues during 1952-53. The Act provides for the levy of tax up to 6 annas per imperial gallon.

The scheme of the Act provides for the levy of tax from the retail dealers though there is provision for charging tax at the wholesale stage also by agreement with the wholesalers and the question of realizing the tax from the wholesalers is being examined.

The Bihar Electricity Duty Act 1948

This tax is being levied with effect from the 1st April, 1948. The Act provides for the levy of duty at a rate not exceeding one anna per unit of energy as may, from time to time, be fixed by the State Government, in respect of metered premises ; and, for unmetered premises, the rate of tax depends on the wattage of each lamp, varying between 5 annas and 15 annas. The rate of duty per unit of energy consumed in metered premises was fixed at 6 pies with effect from the 1st April, 1948, and the same rate is continuing at present.

The Act also provides for exemption from tax of the energy consumed (a) by the Central Government or sold to the Central Government for their consumption ; (b) in the construction, maintenance or operation of railways ; (c) in the construction, maintenance of electrical undertakings by the licencees ; (d) in any mine or industrial undertaking ; and (e) in such other cases as the State Government may allow.

The total revenue from the above taxes in Bihar since 1946-47 is given in the following table :—

(In Rupees)

Year		Agricultural Income-tax Rs.	Entertainment Tax Rs.	Motor Spirit Rs.	Electricity Duty Rs
1946-47	...	26,80,292	....	....	....
1947-48	...	25,23,434	....	....	....
1948-49	...	32,09,949	22,59,795	....	1,21,341
1949-50	...	44,05,328	33,91,589	24,36,307	6,03,733
1950-51	...	69,16,255	35,88,243	....	9,09,606
1951-52	...	57,30,041	37,90,981	31,75,532	11,87,957

II. FINANCES OF PART B STATES

§1. *FINANCIAL INTEGRATION OF INDIAN STATES*

Before we describe the finances of Part B States, a brief account may be given of the changes in the pattern of the fiscal and financial relationship between the Union and the former Indian States. Three types of changes have been effected. Firstly, a very large number of the former States have been merged in the Indian Provinces. Secondly, Chief Commissioner's States like Tripura, Manipur, Bhopal, Kutch, Himachal Pradesh, Bilaspur and Vindhya Pradesh have been formed. Such States are centrally administered. Finally, some States continue by themselves like Hyderabad or Mysore; in others, separate Unions like Saurashtra, Madhya Bharat, Patiala and East Punjab States Union (Pepsu) or Rajasthan have been formed.

To consider the problems of financial integration a committee was appointed in October 1948 under the Chairmanship of Mr. V. T. Krishnamachari to enquire into the structure of public finance of these States and to advise on the integration of federal finance in those States with that of the Indian Union. The recommendations of this committee have, with certain agreed modifications, been accepted by the Government of India and the Government of the States concerned. The scheme of integration, which took effect from the 1st April 1950, places the States and Unions in the same position as the Indian Provinces *vis-à-vis* the Centre. The present composite Governments of these States has been divided on a functional basis and the Centre has taken over the Central subjects and services from these States with the related assets and liabilities. But since some of these States were financing, what would be Provincial services from the surplus of their revenue from Central subjects, some form of financial assistance, to them to meet the dislocation caused by the lifting of federal revenue and expenditure from their budgets, became necessary. Following the Committee's recommendations, for a transitional period of ten years, the Centre has agreed to make good (with certain adjustments) to the States the difference between the actual federal revenue lost to them and the federal expenditure saved to them as a result of federal financial integration. This reimbursement will be made in full for the first five years and on a diminishing scale for the

next five years. The States will be in the same position as the Provinces in the matter of sharing divisible sources of revenue like income-tax but any grant made to them to cover the federal revenue gap will be set off against this share. States which are left with a sulprus as a result of the integration will retain the surplus but the Privy Purses of the former Rulers of these States will be recovered from them to the extent of this surplus. They will, in addition, get their appropriate share of divisible heads of Central revenue.

A similar problem of financial adjustment also arose in the case of the former Indian Provinces into which a large number of Indian States, of varying sizes and varying stages of development were merged. The Krishnamachari Committee enquired into this problem as it arose from the merger of Baroda in Bombay and they suggested that assistance should be given to Bombay on the same pattern as to the continuing States and Unions to meet the dislocation caused by federal financial integration. The Government of India accepted this suggestion and applied it uniformly to all the Provinces in which Indian States were merged and provision has been made in the budgets for this assistance.[1]

The assimilation of these States with the rest of the country has not only brought about financial integration but also has made India one economic unit. The Krishnamachari Committee has achieved what the British rule failed to achieve for over a century and half. As a result of the economic unification of the country the people of these States will share the same opportunities for progress and development as will be given to the former Indian Provinces.

§2. *BUDGETARY POSITION*

An overall budgetary position on revenue account of Part B States is given in the following table :—

(Crores of Rupees)

	1950-51 (Accounts)	1951-52 (Revised)	1952-53 (Budget)
Revenue ...	92.83	105.44	104.62
Expenditure ...	91.30	103.20	107.37
Surplus (+) or Deficit (—)	+ 1.53	+2.24	—2.75

1 Vide the Budget Speech of Dr. John Mathai in introducing the Government of India Budget for 1950-51.

The account for 1950-51 shows a small surplus of Rs. 1.53 crores. In 1951-52 in the revised estimates the original budget deficit of Rs. 0.73 crores was converted into a surplus of Rs. 2.24 crores. This was due to an improvement in the revenue position of Hyderabad, Mysore, Travancore, Cochin, Pepsu and Rajasthan.

The budget for 1952-53, based on the taxation level of 1951-52, shows a deficit of Rs. 2.75 crores and a rise in expenditure from Rs. 103.20 crores (1952-53) to Rs. 107.37 crores in 1952-53. Rajasthan shows the budget deficit of Rs. 0.94 crore, followed by Mysore of Rs. 0.84 crore, Pepsu of Rs. 0.63 crore and Hyderabad of Rs. 0.45 crore. The States of Madhya Bharat, Travancore, Cochin and Saurashtra show nominal surpluses aggregating Rs. 0.11 crore.

The total revenue and expenditure of all the Part B States is given in the following table :—

(Thousands of Rupees)

States		Total Revenue	Total Expenditure	Surplus (+) or Deficit (—)
Hyderabad				
1950-51	...	26,17,61	27,55,00	— 1,37,39
1951-52	...	29,08,68	29,07,87	+ 81
1952-53	...	26,56,17	27,01,48	— 45,31
Madhya Bharat				
1950-51	...	9,84,45	11,13,46	— 1,29,01
1951-52	...	10,66,00	10,86,00	— 20.00
1952-53	...	10,96,00	10,91,00	+ 5,00
Mysore				
1950-51	...	14,40,50	13,51,59	+ 88,91
1951-52	...	18,93,93	18,61,80	+ 32,13
1952-53	...	19,82,85	20,66,80	— 83,95
Pepsu				
1950-51	...	6,04,34	5,03,11	+ 1,01,23
1951-52	...	6,10,02	5,12,20	+ 97,82
1952-53	...	5,90,97	6,53,63	— 62,66
Rajasthan				
1950-51	...	14,60.53	13,91,29	+ 69,24
1951-52	...	15,96,52	16,03,31	— 6,79
1952-53	...	16,32,18	17,25,66	— 93,48
Saurashtra				
1950-51	...	7,76,97	7,42,21	+ 34.76
1951-52	...	7,64,15	7,93,68	— 29,53
1952-53	...	8,73,24	8,71,94	+ 1,30
Travancore-Cochin				
1950-51	...	13,99,14	12,73,72	+ 1,25,42
1951-52	...	17,05,10	15,55,41	+ 1,49,69
1952-53	...	16,30,73	16,26,15	+ 4,58

Distribution of Revenue and Expenditure

The distribution of the major heads of tax revenue and expenditure for 1950-51, 1951-52 and 1952-53 is shown in the following table :—

(Rupees in Lakhs)

Major Heads of Tax Revenue—		1950-51 (Accounts)	1951-52 (Revised)	1952-53 (Budget)
Customs	...	4,96 **(7.97)**	4,91 **(7.52)**	3,43 **(5.20)**
Taxes on Income	...	80 **(1.29)**	1,17 **(1.79)**	1,27 **(1.93)**
Land Revenue	...	16,36 **(26.30)**	15,67 **(23.99)**	17,52 **(26.56)**
Sales Tax	...	5,08 **(8.17)**	5,65 **(8.65)**	5,91 **(8.96)**
Excise	...	20,29 **(32.62)**	21,21 **(32.47)**	21,00 **(31.83)**
Stamps	...	2,97 **(4.77)**	3,10 **(4.75)**	3,17 **(4.81)**
Total Tax Revenue	...	**62,20**	**65.33**	**65.97**
Major Heads of Expenditure—				
Direct Demand on Revenue	...	8,24 **(9.03)**	9,60 **(9.30)**	10,95 **(10.20)**
Irrigation	...	2,80 **(3.07)**	4,44 **(4.30)**	3,87 **(3.60)**
Debt Services	...	4,78 **(5.24)**	4,30 **(4.17)**	4,30 **(4.00)**
Security Services	...	23,91 **(26.19)**	26,03 **(25.22)**	24,02 **(22.37)**
Social Services	...	27,39 **(30.00)**	33,24 **(32.21)**	37,07 **(34.53)**
Total Expenditure	...	**91.30**	**103,20**	**107.37**

Note :—Figures in brackets are percentages of the respective totals.

The above table is interesting in pointing out the relative importance of the various heads of tax revenue in Part A and B States. Unlike Part A States, where income-tax accounts for the biggest source of tax revenue, in Part B States excise tops other sources of revenue (31.83 per cent) closely followed by land revenue (26.56 per cent). Income-tax and sales tax, which have been only recently introduced in some of the States, are bound to be the most important sources of revenue in future.

During 1952-53 the percentage of expenditure on social and security services is 34.5 per cent and 22.4 per cent respectively. In Mysore and Travancore-Cochin the expenditure on social services is substantially higher than on security services, while in Saurashtra and Rajasthan expenditure on security services is higher than on social services. In the rest of the States the expenditure on security and social services, is more or less, the same.

Revenue Gap Payments

Revenue gap payments by the Centre to Hyderabad, Mysore, Travancore-Cochin and Saurashtra are placed at Rs. 10.41 crores in 1952-53 and receipts from the divisible pool of income-tax to Pepsu, Madhya Bharat and Rajasthan at Rs. 0.31 crore (1952-53). The following table shows the allocation of income-tax and grants-in-aid from the Centre to Part B States :—

ALLOCATION OF INCOME TAX AND GRANTS-IN-AID FROM THE CENTRE, TO PART B STATES

(Lakhs of Rupees)

	Revenue Gap Payments			Income Tax Allocations		
	1951-52 Budget	1951-52 Revised	1952-53 Budget	1951-52 Budget	1951-52 Revised	1952-53 Budget
Hyderabad	1,16	1,16	1,16	—	—	—
Madhya Bharat	—	—	—	16	6	7
Mysore	3,45	3,45	3,45	—	—	—
Pepsu	—	—	—	22	15	11
Rajasthan	—	—	—	17	13	13
Saurashtra	2,50	3,00	2,75	—	—	—
Travancore-Cochin	2,80	3,63	3,05	—	—	—
Total	**9,91**	**11,24**	**10,41**	**55**	**34**	**31**

§3. *PER CAPITA EXPENDITURE*

It is interesting to compare the per capita expenditure in Part A and Part B States. The following table shows the per capita expenditure in Part A and Part B States for 1952-53.

PER CAPITA REVENUE AND EXPENDITURE, 1952-53
PART A STATES

(In Rupees)

States	Revenue	Tax Revenue	Expenditure	Expenditure on Security Services	Expenditure on Social Services
Assam ..	11.01	7.14	13.80	2.36	4.03
Bihar ..	7.07	5.50	7.41	1.95	2.20
Bombay ..	16.43	12.99	17.58	5.45	5.92
Madhya Pradesh	9.45	8.04	9.27	2.34	2.77
Madras ..	11.22	8.53	11.37	3.22	4.19
Orissa ..	8.04	5.11	8.24	2.33	2.25
Punjab ..	13.39	8.48	13.41	4.15	3.31
Uttar Pradesh ..	9.89	7.37	9.96	3.07	2.74
West Bengal ..	14.49	12.07	16.59	4.56	4.99
All States ..	**11.07**	**8.45**	**11.59**	**3.31**	**3.62**

PER CAPITA REVENUE AND EXPENDITURE, 1952-53
PART B STATES

(In Rupees)

States	Revenue	Tax Revenue	Expenditure	Expenditure on Security Services	Expenditure on Social Services
Hyderabad ..	14.0	11.1	14.3	3.6	3.8
Madhya Bharat ..	13.6	10.8	13.6	3.8	4.7
Mysore ..	20.9	7.4	22.3	2.5	12.7
Pepsu ..	17.0	10.7	18.8	5.1	5.3
Rajasthan ..	10.5	7.7	11.1	3.4	3.1
Saurashtra ..	20.7	9.0	20.7	6.8	6.1
Travancore-Cochin ..	17.2	10.6	17.1	2.1	5.3
All States ..	**15.2**	**9.6**	**15.6**	**3.5**	**5.4**

The per capita revenue as well as per capita tax revenue are highest in Bombay at Rs. 16.43 and Rs. 12.99 respectively. The per capita revenue and tax revenue are lowest in Bihar, the figures being Rs. 7.07 and Rs. 5.50 respectively. The per capita revenue and tax revenue for all Part A States is Rs. 11.07 and Rs. 8.45 respectively.

The per capita expenditure on security and social services for all Part A States is Rs. 3.31 and Rs. 3.62 respectively. Bombay with Rs. 5.92 and Bihar with Rs. 2.20 show the highest and lowest amounts of per capita expenditure on social services.

The average per capita expenditure for all Part A States is Rs. 11.59 ; Bombay has the highest per capita expenditure at Rs. 17.58 and Bihar the lowest at Rs. 7.41.

The per capita revenue and tax revenue for all Part B States is Rs. 15.2 and Rs. 9.6 respectively as compared with Rs. 11.07 and 8.45 in Part A States. The per capita expenditure on security and social services is Rs. 3.5 and Rs. 5.4 respectively which is higher than that of Part A States (Rs. 3.31 and Rs. 3.62). Mysore spends the highest per capita amount on social services followed by Saurashtra with Rs. 6.1. Saurashtra, Pepsu spend Rs. 6.7 and Rs. 5.1 respectively on security services. The lowest amount on security services is spent in Travancore-Cochin, Rs. 2.1.

From the above tables it appears that the per capita revenue of Mysore (Rs. 20.9), Saurashtra (Rs. 20.7), Travancore-Cochin (Rs. 17.2) and Pepsu (Rs. 17.0) is higher than that of any other Part A State. Mysore spends the highest amount on social services among all the Part A and Part B States. The expenditure on social services of Saurashtra (6.1) Pepsu (5.3) and Travancore-Cochin (Rs. 5.3) is higher than that of any other Part A State (except Bombay with Rs. 5.9.)

The inevitable conclusion is that the finances of Part B States appear to be better than that of Part A States. With larger receipts from sales tax, which has been the most prolific source of revenue in Part A States since 1938-39, the future of Part B States is rather bright. Besides, with the impact of the Five-Year Plan on the economy of the country the revenues of Part B States are bound to show an upward tendency.

§4. *CONCLUSIONS*

The principal sources of revenue of the States as well as those of the Union have now been reviewed in each of their principal aspects. In the present section an attempt will be made to point out some broad features of the Indian tax structure.

The one general conclusion to which I have come from the study of the Indian tax system is that the *total burden of taxation is not excessive.* This assertion is in harmony with the conclusion arrived at by Dr. Anstey that the Indian does not appear to have

been obviously overtaxed. The above conclusion of course does not imply that the distribution of taxation is satisfactory. *The chief fault of the Indian tax system lies in its unsatisfactory distribution of taxation.* Let us consider a few fundamental facts which show the burden and incidence of taxation in India.

National Income & Tax Revenue

The total estimated revenue of the Central and State Governments for 1951-52 is placed at Rs. 758 crores of which tax revenue is Rs. 633 crores or 84 per cent of total revenue. The per capita taxation of the Central and the State Governments in 1951-52 is Rs. 18. Income-tax collections (including agricultural income-tax) at Rs. 169 crores account for 27 per cent of total tax revenues.

Let us now consider a few facts relating to the national income of India. In August, 1949 the National Income Committee was appointed by the Government of India. The national income (net national output at factor cost) of the Indian Union for 1948-49, as estimated by the Committee, is Rs. 8,710 crores. The per capita national income with an estimated population in 1948 of 341 millions, was placed at Rs. 255. The following table shows the national income according to its origin :—

NATIONAL INCOME OF THE INDIAN UNION, 1948-49
(By Industrial Origin)

Item	Net output Crores of Rupees	Percentage	No. of persons engaged (Lakhs)
1. Total of agriculture ...	4,150	47.6	9,05
2. Total of mining, manufacturing and hand-trades ...	1,500	17.2	1,87
3. Total of commerce, transport and communications ...	1,700	19.5	1,07
4. Total of other services ...	1,380	15.9	1,28
5. Net domestic product at factor cost	8,730	100.2	13,27
6. Net earned income from abroad	(–)20	(–) 0.2	
7. Net national output at factor cost : national income ...	8,710	100.0	...

From the above figures it will appear that agriculture contributed Rs. 4,150 crores or 47.6 per cent of the national income ; commerce, transport and communications came next with Rs. 1,70 crores or 19.5 per cent ; mining, manufacturing and hand-trades accounted for Rs. 1,500 crores or 17.2 per cent. Among 'other services' which contributed Rs. 1,380 crores, Government services (administration) and house property accounted for Rs. 460 crores and Rs. 450 crores respectively.

It is important to point out that out of a total net domestic output of Rs. 8,730 crores the share of the private sector was Rs. 7,970 crores and that of Government enterprises and administration Rs. 760 crores. The Government acquired by way of taxes and miscellaneous fees Rs. 690 crores or 7.9 per cent of private income.

It is interesting to compare the percentage of national income to total revenue in some of the countries of the world. This has been worked out in Table No. XIII.

It is risky to compare the percentage of total revenue to national income of one country with another as the conditions are not identical. Nevertheless, it will appear that in India the total revenue is only 4 per cent of the national income of the country. The figure is unusually low and it bears out the assertion that India is not overtaxed as compared with other countries.

The distribution of the revenues of the Government of India, Part A and Part B States in 1951-52 (revised) from the principal heads of revenue is as follows :—

(Crores of Rupees)

Items		1950-51	1951-52	1952-53
Customs	...	157.15	232.00	165.00
Union Excise Duties	...	67.54	84.30	86.00
Corporation Tax	...	40.49	37.55	30.53
Income Tax	...	132.73	137.45	124.47
Land Revenue	...	49.57	49.57	59.25
Sales Tax	...	56.41	53.38	51.57
Excise	...	47.32	47.49	47.07
Stamps	...	22.19	23.28	23.36

From the above figures it will appear that income-tax (including agricultural income-tax) accounts for 27 per cent of the total revenues of the country ; the rest of the revenue is, more or less, raised from indirect taxes. Out of the total revenues of

the Centre, Part A and Part B States in 1951-52 of Rs. 797.81 crores, the revenue from customs, union excise duties, sales tax and excise (country liquor) amounted for Rs. 232.00 crores, Rs. 84.30 crores, Rs. 53.38 crores and Rs. 47.49 crores respectively. The above figures unmistakably point out the predominance of indirect taxes in the tax structure of the country. Broadly speaking it may be said that the burden of taxation is not satisfactorily distributed amongst different classes in the country.

Another important feature of the tax system is that whereas there has been a shifting of wealth (as a result of the War and inflation) between different classes in society and between urban and rural areas, the tax structure has not been adjusted to meet such changes. For instance, the burden of land revenue and rentals has not increased though union excise duties and sales tax (indirect taxes) have phenomenally increased. This has obviously resulted in placing a heavier burden on non-landholding classes.

Besides, the prices of commercial and food crops increased phenomenally. The landlords and cultivators enormously benefited by such a rise in prices but the burden of taxation on them was not increased commensurate with their gains.

Similarly, on account of war and inflation wealth has more and more passed into the hands of wealthier sections of the country. It was universally felt that huge amounts of wealth had escaped taxation. The Government, therefore, appointed the Income Tax Investigation Commission in 1947 for investigating concealed incomes which had escaped taxation during the period 1939-47. The Commission up to March 1952 has disposed of 661 cases involving a concealed income of Rs. 29.16 crores, of which as much as Rs. 25.40 crores was accounted for by cases settled by agreement.[1]

The above analysis enables us to draw the following conclusion : the action of taxes which were imposed during the period disturbed the equilibrium between the distribution of national income and between the different sectors of the community arranged the tax structure. What is most needed now is a re-adjust-

[1] The total amount of income brought to light under the scheme of voluntary disclosures before the Commission up to March 31, 1952 was Rs. 94.62 crores.

TABLE No. XIII

Country	Year	Total Revenue	National Income	Percentage of Total Revenue to National Income	Currency
India ...	1948-49	372	8,710	4 Per cent	Crores of Rupees
New Zealand ...	1948-49	122	419	29 ,,	Millions of New Zealand Pounds
United Kingdom ...	1948-49	4,007	9,896	40 ,,	Millions of Pounds Sterling
U. S. A. ...	1948-49	38,246	223,500	17 ,,	Millions of Dollars
Australia ...	1948-49	481	1,955	25 ,,	Millions of Australian Pounds
Canada ...	1948-49	2,771	12,560	22 ,,	Millions of Canadian Dollars

Vide *Report on Currency and Finance.* .Reserve Bank of India (1951-52) p. 134-36.

ment of tax structure with the changes in the economic pattern of the country. The opportunity for confiscatory taxes which are levied only once has been lost. The guiding principle in tax policy should be that taxation should create a new economic equilibrium between profits, wages, rent, and other sources of national income. Fiscal policy should aim in removing economic inequalities brought about by recent play of economic forces. If it fails in achieving this objective the task of inoning out the remaining inequalities should be left over to the proposed tax measure viz. the estate duties.

X

LOCAL TAXATION

§1. *INTRODUCTORY*

In the studies on Provincial finance in India, inadequate attention has been paid to the problems of the financial relationship between the Provincial Governments and local authorities. The administrative and financial problems of Provincial Governments and local authorities, though closely knit together, are treated in isolation. The financial policy of the Provincial Government has no relation to that of local authorities. The tax policy of each local authority is also separate and has no relation to that of the rest.

The disadvantages of such an uncontrolled and un-co-ordinated tax system are obvious. It has created inequalities of tax burdens between individuals and between one district and another. The widely different tax rates imposed by municipalities and district boards on goods and merchandise entering their limits (e.g. in the shape of octroi) has made it impossible to know the exact burden which trade and industry has to bear or the relative burden on different commodities. This un-co-ordinated system has also resulted in a lack of efficiency and economy in the administration of local services. Lastly, it has not led to a healthy development of local self-government, towards what Sidney Webb calls that national minimum of efficiency in local services, which is now regarded as indispensable in the interests of the nation as a whole.

The object of this chapter is to consider briefly the present situation and the lines along which the financial relations between the State Governments and local authorities may be co-ordinated, so that a greater element of efficiency, economy and harmony may be introduced into the tax system of the country. With this end in view the financial problems of local authorities may be studied in two parts:

(i) the problem of areas and functions and the resulting inequality in tax burdens; and

(ii) the principles and methods to be followed by the State Governments in rendering help to local authorities.

§2. *THE PROBLEM OF AREAS AND FUNCTIONS*

Causes of Decay of Village Communities

To achieve efficiency in local tax administration and to distribute equitably the tax burden, a scientific delineation of local areas is necessary. The size and area of the local authorities has been determined in India, as in most other countries, by political and historical factors. In pre-British days the village was an autonomous body; its local self-government functions were in the hands of village communities. This autonomous character of village life gradually disappeared under British rule owing to the establishment of local civil and criminal courts, the present revenue and police organization, the increase of communications and the growth of individualism.[1]

This process of transformation was completed when the East India Company, to facilitate the collection of land revenue, divided the country into new regional units (districts) and placed them under the charge of Collectors. These radical changes touched the root of local self-government in India. This changed atmosphere, surcharged with individualism, led to the final disappearance of those village communities which had formed the basic unit of local self-government in the country. The village *panchayat,* the executive body of the village communities, sanctioned by both ancient law and custom, became an impotent body on account of the rising tide of individualism and the increasing importance of civil and criminal courts.

At the present time, beginning with the Corporations of Bombay, Calcutta and Madras, we have several layers of Governmental units consisting of municipalities, district boards, taluk boards, notified areas and cantonments, down to the *panchayats.* The exact number of these units varies in different States and also within different districts of the same State. But generally for rural areas the district board is the unit of local-self government.

[1] *Report of the Royal Commission on Decentralization Cmd.* 5460 (1908).

The Area Served by the District Boards is too Large

The area served by the district boards is unquestionably too big. Whereas in England there is one local body to every four square miles and in France to every six square miles, in India there is a local board to 1.494 square miles.[1] The unwieldy size of the areas under district boards has very important consequences in the raising of taxes and in the efficiency of administration of local services.

First, size has an important bearing, as the Taxation Enquiry Committee observed, on the question of taxation, since unquestionably the facility for raising contributions for local purposes increases as the size of the unit of taxation decreases.[2] With an inadequate and corrupt staff, the chances for fraud, tax evasion and embezzlement become extraordinarily high in India. Moreover, the lack of proper facilities in raising taxes due to too large areas results in maldistribution of tax burdens between the different classes of rural population. The large landholders and village traders, who also perform the work of indigenous bankers, do not contribute their fair share.

Secondly, the district boards are not able to pay adequate attention to all the different parts of their large areas. The Council of a small English borough, observes Professor Cannan, finds difficulty enough in reconciling or disregarding the demands of different parts of its area for road repairs, lighting, parks, and suchlike things.[3] A district board in India, covering an area of more than 1,400 square miles, necessarily finds it extremely difficult to reconcile the claims and counter-claims of the thousands of villages under it.

Thirdly, the present areas of the district boards are unsuitable for the efficient and economic performance of the services undertaken by them.

Optimum Size of Local Bodies

An inquiry into the character of the services performed by such local authorities leads us to consider the optimum size of

[1] See *Report of the Indian Taxation Enquiry Committee* (1924-5)

[2] Ibid, p. 290. The Committee observed: 'In rural areas the jurisdictions of the local bodies are too large from the fiscal point of view' (p. 322).

[3] Cannan, *The History of Local Rates in England* (P.S. King), 2nd edition, pp. 174-5.

such bodies, in order that the unnecessary waste in both the raising of revenue and the provision of a given quantity and quality of service, may be reduced to a minimum. In the absence of such knowledge the best efforts of the most capable administrators may not produce desirable and satisfactory results. For, 'if the governmental organization is defective', says Professor Lutz, 'it becomes impossible to measure the relation between efforts and results, and immense sums may continue to be poured into certain administrative channels, only to disappear without a trace, like the river that flows into desert sands.'[1]

Theoretically, to improve the relation between resources and functions in the case of local authorities two courses of action are open :

(i) jurisdictional changes ; and
(ii) re-allocation of functions between units which can perform them in the most efficient way.

A plea for the Revival of Village Panchayats

Jurisdictional maladjustments cannot be easily corrected. The best way to correct such maladjustments, with the least disturbance to the existing administration, would be to revive village *panchayats*. The Indian village *panchayats* have been from time immemorial the basic unit of administration. Their revival would increase efficiency, economy and good administration in local areas and would facilitate the reform of maladjusted tax-burdens and the introduction of a rational policy for the determination of the aggregate public expenditure, great or small, in directions which would avoid waste and increase efficiency.

The Royal Commission upon Decentralization in India (1908), clearly visualized the importance of local governmental units, and in order to arrive at a better level of administration in the field of local self-government, strongly recommended the desirability of starting such bodies, in the following terms :

We are of opinion that the foundation of any stable edifice which shall associate the people with administration must be the

[1] Lutz, *Public Finance*, p. 110.

village, as being an area of greater antiquity than administrative creations, such as *tahsils,* and one in which the people are known to one another, and have interests which converge on definite and well-recognized objects like water supply and drainage. It is probable, indeed, that the scant success of the efforts hitherto made to introduce a system of rural self-government is largely due to the fact that we have not built up from the bottom.[1]

The administration of village *panchayats* as basic units of local self-government is now regulated by separate enactments in most of the States. It may be pointed out that the policy of fostering village *panchayats* is included as a 'directive principle of State policy'. Article 40 of the Constitution, provides that 'the State shall take steps to organize village *panchayats* and endow them with such powers and authority as may be necessary to enable them to function as units of self-government'.

Recently there has been a tendency for the revival of village *panchayats* in most of the States. In Madras the Village *Panchayats* Act of 1950 (Madras Act X 1950) removed village *panchayats* from the operation of the Madras Local Boards Act of 1920. The new Act gives additional powers to the *panchayats.* Under it the *panchayats* have a distinctive legal position. The new Act divides *panchayats* into two classes—Class I, those with an estimated population of 5,000 and over, and having an estimated annual income of not less than Rs. 10,000/-; and Class II, *panchayats* other than those in Class I with a minimum population of 500 persons.

In the U.P. the village *panchayats* are governed by the U.P. Panchayat Raj Act, 1943 (U.P. Act No. XXVI of 1947). Under this Act all adult residents in a village are incorporated under the name of a *Gaon Sabha,* and the *Gaon Panchayat* is the executive Committee of the *Sabha.* 35,000 village *panchayats* for 1,10,000 villages in the State have been established under the Act.

In Bihar the village *panchayats* are governed by the Bihar Panchayat Raj Act, 1947 (Bihar Act VII of 1948). The *panchayat* under this Act is a body corporate consisting of all adult

[1] Cmd. 4360 (1908), par, 699.

residents of the area for which a *Gram Panchayat* is established. The village *panchayat* is the policy-laying and budget-making body, whereas the executive functions are performed by an executive committee of which the head (known as the *Mukhiya*) is directly elected. The *Mukhiya* (headman) appoints the members of the executive committee from among the members of the *Gram Panchayat.*

Re-allocation of Functions between District Boards and Village Panchayats

The revival of village *panchayats* should be followed by a policy of re-allocation of functions between district boards and such units. The present area of the district boards being too large, the transfer of the administration of services such as education, village sanitation and drainage, registration of vital statistics, vaccination, prevention of diseases of animals and destruction of insects and pests, to village *panchayats,* would undoubtedly increase efficiency and economy in their administration. On the other hand, the provision of hospitals, building of highways, paths and bridges, improvement of agriculture, development of rural industries, and what is broadly conveyed by the term 'rural reconstruction' should be left to district boards.

It should not, however, be forgotten that this policy of decentralization of functional readjustments accompanied by financial grants, must be accompanied by centralized control to achieve good results. The district boards, in the interests of a well-regulated, co-ordinated and uniform policy, must be given powers of control and supervision over the *panchayats.* For similar reasons, the services performed by the district boards must be properly supervised by the State Governments.

This policy of functional re-allocation, accompanied by centralized control, raises a number of important problems. We shall, however, consider only two aspects of these problems; First, as the finances of local authorities are low all over the country, methods are suggested to increase their resources; secondly, to supplement their inadequate resources, the way in which the State Governments should help and supervise, is indicated.

In most of the Acts recently passed to organize village *panchayats,* their functions are divided into 'obligatory' and 'discretionary' categories. The allocation of functions is not uniform in all the States. However, broadly speaking, among the important obligatory functions the supply of water for domestic use; cleaning of public roads, drains, *bunds,* (embankments) tanks, wells (other than tanks and wells used for irrigation) and other public places or works; sanitation, and conservancy, prevention and abatement of nuisances, may be mentioned.

Among the discretionary functions, the construction and maintenance of public latrines, markets and slaughterhouses; laying out of playgrounds and public gardens; planting trees; establishment of village libraries and reading rooms, relief of the destitute and the sick; control of fairs; opening and maintaining public landing places; cart stands and cattle sheds; registration of births and deaths, opening and maintaining elementary schools and dispensaries, may be stated.[1]

§3. *MAIN SOURCES OF INCOME OF LOCAL AUTHORITIES*

Income of Municipalities

The sources of income of local authorities may be grouped under four heads:

(1) Taxes on trade.
(2) Taxes on property.
(3) Taxes on persons.
(4) Fees and licences.

(1) *Taxes on Trade*

Octroi—Municipalities place too much reliance on indirect taxes. Octroi, terminal-taxes and tolls form their most important sources of revenue. All these are ancient and primitive taxes and have their historical basis in the benefit of the market in which producer and trader required safety to carry on their market opera-

1 See the *Report of The Local Finance Enquiry Committee* (1951) pp. 284-5.

tions in isolation. This was justified in unsettled times but is now hardly a legitimate basis for their imposition.

These duties are levied on goods and merchandise entering municipal limits. In the form in which they are levied in India they offend against all the canons of taxation. They are uncertain in their incidence. They not only hamper the trade and industry of the country but fall with inequitable weight on poorer classes whose necessaries of life form the main items of such tax receipts.

Lord Stamp summed up the defects of octroi as follows:—

> In my judgment, both theoretically and on the result of experience, no country can be progressive that relies to any extent upon octroi, which has nearly every vice.

The popularity of these taxes, in spite of these grave defects, is due to the fact that as their incidence is shifted it becomes very difficult to determine who ultimately bears the burden of the tax. The tax is 'wrapped up in the price of the commodity'. The collection of octroi through the agency of the railway has removed some of the administrative difficulties, and the municipalities have in this way also transferred the odium of collection to the railway company.

Apart from these features it is to be regretted that the Government of India and the State Governments have not so far exercised an effective control over the trade of the country. Customs barriers, which are serious obstacles to international trade, cannot always be easily avoided, on account of political, national or vested interests. Octroi and other internal transit duties are merely customs in disguise. It is unfortunate that even under the Constitution the position of octroi remains, more or less, what it was under the Act of 1935. The Local Finance Committee reluctantly recommend octroi on practical grounds, and suggest that there should be in each State a model schedule for octroi approved by the State Government and that departures from that schedule should not be permitted by any subordinate authority, except with the previous approval of the State Government.[1] Such a schedule

[1] See the *Report on The Local Finance Enquiry Committee* (1951), p. 153.

should prescribe the list of articles and the maximum rates permissible, in order that wide variations in the rates may be avoided. At present the schedule of rates varies from State to State and even from one local body to another within the same State in respect of the same article. They further recommend that in framing the model schedule the rates on the necessaries of life should be kept as low as possible. Meanwhile, the State Governments should see that:

(i) Octroi is low and as nearly uniform as possible.
(ii) It does not bear unfairly on through trade.
(iii) The cost of collection is reduced.
(iv) Its administration is improved.

(2) *Taxes on Property*

(a) *Municipalities* Property tax is levied by municipalities in India for four important purposes:—

(a) a tax for general purposes on lands and buildings;
(b) a water and drainage tax;
(c) a lighting tax;
(d) a conservancy or scavenging tax.

The income from property taxes during 1946-47 as given in Table No. XIV shows :

It will be seen from the above table that the tax is of major importance in Madras, West Bengal, Bombay, Bihar, Orissa and Assam. In Bombay the rates of house tax in many municipalities are far lower than in municipalities of corresponding size in Madras. In Punjab and Uttar Pradesh it is of comparatively minor importance. It is levied in a few municipal areas and where levied the rate is very low. There are great possibilities of development of this source in these two States. In Madras, West Bengal, Assam and Orissa the property tax is levied by all municipalities. In Bombay, the house tax is levied by all municipalities, except by three municipalities, namely, Ahmadabad, Gudguddapur and Ulvi. In Bihar, house tax is levied by 54 out of 57 municipalities. In Uttar Pradesh, it is levied only in 33 out of 110 municipalities.[1]

[1] *See the Report on The Local Finance Enquiry Committee* (1951) p. 71.

It is to be regretted that while the tendency in local finance of most countries is towards the replacement of indirect by direct taxes, in India direct taxation of property has not made much progress in municipal finance. The octroi, with all its unpalatable features as we have seen, still dominates the field of local finance. In taxation of houses the two cardinal principles of benefit and ability are harmoniously combined. Taxation of houses covers the payment for definite services, such as street-lighting, drainage, communication, etc., which 'benefit' property. House property also affords a rough but tangible measure of the owner's (or occupier's) capacity to pay.

The main reason for the low yield of taxes on houses is the reluctance of municipal commissioners, dependent on the suffrage of the rate-payers, to increase or introduce the house tax. The conclusions with regard to the unhealthy features of municipal administration may be expressed in the words of the Bengal Government: Municipal finance will continue to present a problem of perplexing difficulty so long as the municipal bodies display a reluctance to tap adequately the resources at their disposal. Unwillingness to face the unpleasant duty of fresh and enhanced taxation, laxity in the recovery of taxes, current as well as arrears, and disregard of financial canons, retard the path of municipal progress.

(b) *District Boards : Local Fund Cess*

The income of the district boards from each of the important sources heads in round of the States is shown in Table No. XV.

The sheet anchor of the revenue of district boards is a cess on land called the local rate or the local fund cess in different States. It is collected through Government agency along with the land revenue and credited to the district board funds after deducting the cost of collection.

The basis of the assessment of the cess varies from State to State. Table No. XVI shows the rates and basis of assessment.

TABLE NO. XIV

Income of District Boards

(In Rupees)

States	Total income	Rates	Educational receipts	Medical receipts	Government grant	Miscellaneous receipts
Madras	5,72,78,682	2,61,92,380	30,75,884	1,03,637	1,73,20,000	29,48,363
Bombay (1944–45) ..	4,63,30,468	61,74,191	1,01,981	1,18,800	1,41,56,254	3,36,775
Bengal	74,31,976	37,13,818	21,224	2,00,911	26,14,751	65,697
U. P.	3,13,79,890	89,68,147	18,10,000	2,60,000	1,52,57,266	3,30,000
Punjab 1947 ..	1,16,03,637	25,78,351	6,06,075	26,281	64,39,329	49,910
Bihar 1947 ..	2,58,56,960	1,06,42,979	....	....	1,20,08,626	....
Orissa ..	52,68,919	11,92,307	....	....	35,86,444	....
M. P. ..	1,55,14,895	37,96,872	30,952	14,803	42,41,071	742
Assam ..	61,65,696	19,19,084	11,663	10,350	32,19,520	9,690

TABLE NO. XV

States	Total taxation income	Income from tax on houses and lands	Income from water rate	Income from conservancy rate	Income from lighting rate
Madras (excluding Madras City)	2,56,20,441	69,41,582	30,53,109	9,63,616	54,34,726
Madras City	1,07,72,642	48,58,855	6,26,877	...	...
Bombay (excluding Bombay City) ..	2,05,89,098	35,21,860	49,38,351	14,67,816	3,14,300
Bombay City	5,43,10,763	87,75,728	1,34,81,288	48,54,811	...
West Bengal (excluding Calcutta) ..	78,35,453	42,77,935	3,95,868	16,06,902	3,06,919
Calcutta City	2,41,59,100	2,19,50,600	levied as a	consolidated	rate
Uttar Pradesh	2,75,10,000	2,370,000	46,90,000	2,00,000	...
Punjab	53,50,878	5,00,027	4,18,191	18,806	...
Bihar	44,63,948	19,28,366	5,26,278	12,73,996	21,823
Orissa	6,31,113	2,15,909	52,205	1,77,647	...
Madhya Pradesh	1,10,96,594	8,66,784	14,09,595	14,73,539	30,521
Assam	10,42,102	4,12,734	2,09,303	3,18,469	44,682

TABLE XVI

States	Name of Cess	Basis of Assessment	Rate
1	2	3	4
Madras ..	Land Cess	Of annual rent value of land which shall be the full assessment payable plus water rate in the case of *ryotwari* and *inam* lands and annual rent in the case of others.	Two annas in the rupee
Bombay ..	Local Fund Cess	Of land revenue.	Three annas in the rupee
West Bengal ..	Road and Public Works Cess	(a) Of annual value of lands or of annual net profits from mines, quarries, tram-ways, etc.	Rupees ten per acre
		(b) On land used for tea, coffee and cin-chona cultivation.	
Uttar Pradesh ..	Local Rate	Of the annual value of land which is de-fined as twice the land revenue payable.	9-3/8 per cent compulsory maximum
Punjab ..	-do-	-do-	One anna to four annas per rupee
Bihar ..	Road and Public Works Cess	(a) Of annual value of lands.	2 annas in the rupee
		(b) Of the annual net profits from mines and quarries.	One anna per rupee
Orissa ..	Local Cess	(a) Of the annual value of lands or annual net profits.	From annas 2 to annas 4 per rupee
	Land Cess	(b) Of the Kamilzama assessed in every zamindari and Malguzari village in Sam-balpur.	12 per cent

As regards the persons who pay the cess, the practice varies from State to State. In *ryotwari* areas it is levied upon the landholder, who may or may not shift it when sub-letting the land. In the Punjab, the local rate is payable by the landlord, but in cases where the land is held by an occupancy tenant at a favourable rent, the landlord may realize a share of the rate from the tenant. In the permanently settled areas of Madras the cess is collected from the landholder who, however, is entitled to receive one-half of it from his tenant. In Bengal, the landlord pays the entire amount of the cess, but is entitled to recover from the tenure-holders the entire amount, less an amount determined at half the rate of the cess for each rupee of rent payable by the latter. The cultivating tenant is liable to pay to the person to whom his rent is payable one-half of the cess.

The local rate forms the most important source of revenue of rural bodies in India. The tax is economical to the board as it is collected along with land revenue. Its assessment, however, in the permanently settled areas, where it involves a special process, adds to the cost of general administration. Where it is levied at a flat rate it is not proportional to the ability of the rate-payer. In areas where it is based on acreage it is not proportional to the taxable capacity of the lands. Nevertheless, the tax, as it is used for purposes of local improvement, benefits the property of the taxpayer. The tax is based on the benefit theory of taxation.

Taxes on Persons

Among the important taxes on persons a tax on circumstances and property, and a tax on professions, trades and callings may be mentioned. A tax on circumstances and property may either be an alternative or a concomitant to a house tax. In small and decaying towns house tax is often a fallacious index of the circumstances of the owners or occupiers. Hence a tax on circumstances and property, in place of a house tax, is levied. In some cases a tax on circumstances and property is a useful supplement to a low house tax.

The present position regarding the levy of professions tax is governed by Article 276 of the Constitution. The Article runs as follows:—

1. Notwithstanding anything in Article 246, no law of the Legislature of a State relating to taxes for the benefit of a State or of a municipality, district board, local board or other local authority therein in respect of professions, trades, callings or employments shall be invalid on the ground that it relates to a tax on income.

2. The total amount payable in respect of any one person to the State or to any one municipality, district board, local board or other local authority in the State by way of taxes on professions trades, callings and employments shall not exceed two hundred and fifty rupees per annum; provided that if in the financial year immediately preceding the commencement of this Constitution there was in force in the case of any State or any such municipality, board or authority a tax on professions, trades, callings or employments the rate or the maximum rate of which exceeded two hundred and fifty rupees per annum such tax may continue to be levied until provision to the contrary is made by Parliament by law, and any law so made by Parliament may be made either generally or in relation to any specified States, municipalities, boards, or authorities.

3. The power of the Legislature of a State to make law as aforesaid with respect to taxes on professions, trades, callings and employments shall not be construed as limiting in any way the power of Parliament to make laws with respect to taxes on income accruing from or arising out of professions, trades, callings and employments.

Under the Constitution the old limit of Rs. 50/-, under the Government of India Act, 1935, has now been raised to Rs. 250/-, which undoubtedly is a welcome change in the powers of the local bodies to levy professions tax. In view of the changed circumstances the State Governments should now advise local bodies to revise the previous schedules of professions tax, so as to increase their resources.

The position in some of the major States regarding the tax on professions may briefly be summarised as follows :—

In Madras, it is levied by all municipalities, district boards and several *panchayats*. The income from this source is substantial. In view of the raising of the limit of Rs. 250 the Madras

Government have advised local bodies to revise their previous schedules up to the maximum permissible.

In Bombay, no municipality levies professions tax as such, but some of them levy small taxes in the form of licence fees on specified trades and callings which are subject to municipal control. This tax is also levied by four or five district boards. The income from this source is negligible. The Government of Bombay are of the opinion that the professions tax can never be a source of much income owing to the disproportionately large collection charges.

In Uttar Pradesh, there are two taxes which are akin to the professions tax :—

(1) A tax on trades, callings, etc., which is assessed on the annual income in ascending scales. This tax is levied only in 13 municipalities out of 110 and yields Rs. 1½ lakhs annually ; and

(2) A tax on circumstances and property, which is at present levied by 12 municipalities and 29 district boards. In rural areas agricultural income is exempt from taxation and the maximum rate is 4 pies in the rupee on income, subject to an aggregate maximum per assessee. District boards depend on this tax to a much greater extent than municipalities. They derive an income of Rs. 12 lakhs per annum from this source.

There is no provision for the levy of a professions tax in the U.P. District Boards Act. Only certain trades and callings can be licensed. The *panchayats* have got powers to levy such a tax.

In West Bengal, a professions tax is levied in the City of Calcutta and other municipalities. A professions tax is levied in rural areas, but the income goes to District School Boards under the Primary Education Act. The Union Boards levy what is called a Union rate, which is their principal source of income and is assessed on the lines of a tax on circumstances and property subject to a maximum of Rs. 84/-.

In Bihar municipalities, there is at present a tax on circumstances and property which is levied in substitution of a tax on holdings. There is no such tax in rural areas.

In Assam, the professions tax is a provincial tax and is not levied by any local body.

The following table shows the income from professions tax during 1946-47 in some of the States in India:

States		Income from professions tax	Percentage of income from professions tax to total municipal income
All India (including the City Corporations of Madras and Calcutta)	..	4,210,398	1.47
Madras (excluding Madras City)	..	1,080,539	4.2
Madras City Corporation	..	510,378	3.8
Bengal (excluding Calcutta City)	..	398,856	5.06
Calcutta City Corporation	..	1,977,600	5.6
Uttar Pradesh	..	360,000	1.2
Punjab	..	3,697	0.06
Madhya Pradesh	..	127,602	1.1
Bihar	..	102,776	2.34
Orissa	..	31,729	4.9

(4) *Fees and Licences.*

The total income from fees and licences for the municipalities during 1946-47, is as follows:—

Madras	22,66,186	19,08,980
Bombay	11,76,014	2,99,157
West Bengal	1,68,057	5,54,810
Punjab	26,447	88,823
Bihar	3,08,959	3,95,865
Orissa	38,233	86,339
Madhya Pradesh	6,60,355	4,35,405
Madras City	2,57,221	1,77,025
Bombay City	22,66,833	9,30,365
Calcutta	16,04,519	2,28,969

The income from fees and licences could be substantially increased if municipal trading is encouraged in India. The scope for municipal trading is vast, and if the municipalities follow a policy of capital development, the income under this head is capable of expansion.

Fees and licences are numerous and are levied for a variety of purposes. Fees for specific services (e.g., scavenging), licence fees on carriages and animals, and licence fees for the regulation of offensive and dangerous trades are levied by almost every municipality in India.

§4. *FINANCIAL CO-ORDINATION BETWEEN THE LOCAL AUTHORITIES AND STATE GOVERNMENTS*

Need for Grants-in-aid

The preceding pages have made it clear that the present financial arrangements of the local authorities are unsatisfactory and need to be changed. Perhaps nothing is more urgently needed in the field of local financial reform than a change in the financial relations of the local authorities and State Governments. Any such change on scientific lines should result in (i) an increase of primary and secondary education, (ii) increased facilities for medical treatment, (iii) an advance in public health activities, development of means of communication and transportation, and (iv) an extensive development of rural reconstruction.

On what lines should a change in the present financial arrangements between the local authorities and State Governments proceed ? The subject is full of difficulties. Any radical suggestion would necessarily invite criticism. We may, however, learn lessons from the financial history of local authorities in England and put in a plea for the adoption of grants-in-aid devised to start a new kind of relationship between the State Governments and the local authorities. The case for grants-in-aid as a measure for the equalization of burdens and for placing local finance on a sounder footing has been made by Sidney Webb on four grounds. They are:

(i) Grants-in-aid are necessary, in the first place, to prevent an extreme inequality of a burden between one district and another.

(ii) They are needed to give weight to the suggestions, criticism, and authoritative advice by which the central authority seeks to secure greater efficiency and economy of administration.

(iii) The third reason for grants-in-aid is that they furnish the only practicable method, consistent with local autonomy, of bringing to bear upon local administration the wisdom of experience, superiority of knowledge, and breadth of view which, as compared with

the administrators of any small town or any rural area, a central executive department cannot fail to acquire, for carrying into effect the general policy which Parliament has prescribed.

(iv) The fourth reason for grants-in-aid is that only by this means can we hope to enforce on all local authorities of the kingdom that national minimum of efficiency in local services which we now see to be indispensable in the national interest.[1]

Advantages of Grants-in-Aid

As pointed out previously, the State Governments have not so far exercised sufficient care, attention, and control in the supervision of local authorities. It is rather unfortunate that people in India think that the greater the direction and control exercised by the State Government the less the field for local autonomy. This, however, is a shortsighted view. To quote Sidney Webb once again: 'A century of experience has demonstrated that it is undesirable for local authorities to be subject to no administrative control whatsoever from a central authority, for them to be left without independent inspection or audit, without access to centralized experience and specialist knowledge, without any enforcement of the minimum indispensably required for the common weal, and without mitigation of the stupendous inequality of local rates that complete autonomy involves.'[2] No local authority exists by itself. Its financial and administrative policies profoundly affect the trade, industries, tax burden and life of people living in other areas. Thus in the interests of a uniform and co-ordinated policy grants-in-aid form the most efficacious lever of central control to harmonize the relations of various local authorities *inter se*.

Again the administrative wisdom and wider experience of the State Government can best be made available for local authorities through a system of grants-in-aid. Local authorities with local fields of vision, may follow a policy which though it may be beneficial to the locality, may be detrimental to the wider interest of

[1] Webb, *Grants-in-Aid*, ch. ii, pp. 15-23.
[2] Webb, *Grants-in-Aid*, ch. ii, p. 18.

the nation as a whole. Grants-in-aid in England before 1888 were 'in most cases devised', says Lord Balfour of Burleigh, 'with a view of guiding local authorities in the desired direction'. The wayward policy followed by local authorities in India can be largely controlled and guided in the right direction through a judicious system of grants-in-aid. And as grants must always bear some relation to the cost of local services, they afford a lever for improving local administration, both in regard to efficiency and economy.

The equalization of tax burdens and the enforcement of a 'national minimum' in locally administered services cannot be attained under the present financial arrangement in India. Poor backward districts possess highly inadequate resources and need larger expenditure for the spread of education, provision of hospitals and improved sanitary facilities, and the development of means of communication and transportation. Under such conditions says Sidney Webb, 'to leave each local authority to pay for its own sanitation, its own schools, its own roads and bridges, its own sick and infirm, and its own aged and poor would mean that some districts would have to incur a rate in the pound ten or even twenty times as great as others.'[1] Hence, in order that poor undeveloped areas may come up to a common minimum standard of adequacy and efficiency of local services, without gross inequality in tax burdens on individuals, a system of grants-in-aid becomes a supreme necessity.

Lastly, at the present time, with the development of means of transportation and communication and the advancement of modern science, national life is becoming more closely knit together. Since no Chinese Wall exists between local authorities, national life is profoundly affected by the ignorance, negligence or poverty of an inefficient or a poor area. As Dr. Finer aptly remarks: 'No area is bacteria-proof, none is bacteriologically self-contained; no area is criminal-proof, none is burglariously insulated.'[2] Hence, in a progressive society the central authority must see that the standard of services performed

[1] Webb, op. cit., p. 17.

[2] Finer, *English Local Government*, p. 28.

by local authorities does not fall below the national minimum. If a local authority cannot come up to a certain standard in the efficiency of its services the central authority must come to its help and raise efficiency. For the ultimate responsibility for the moral and material development of the people, must rest with the nation. People living in poor backward areas should not be denied the minimum civic amenities available to those living in rich areas.

In view of the flagrant disregard of the principle of the 'national minimum' in Indian local self-government, Sidney Webb's classic argument for grants-in-aid is worth extensive quotation :

> We cannot allow Little Pedlington to be free, if it chooses, to have as much small-pox and enteric fever—not to say cholera and bubonic plague—as its inhabitants choose to, rather than take preventive measures which they dislike. We have equally no reason to put up with the horrible bad roads which are all they may wish to pay for. If they are permitted to bring up their children in ignorance, to let them be enfeebled by neglected ailments, and to suffer them to be demoralized by evil courses, it is not the Little Pedlingtonites alone who will have to bear the cost of destitution and criminality thus produced. Hence, modern administrative science is forced to recognize that we are all, in the plainest sense, 'members of one another'.[1]

Grants-in-Aid—their Need in India

The history of grants-in-aid in England reveals that they originated to help the rural classes upon whom, with the development of industrialization and commercialization, the increased burden of taxation began to weigh too heavily. The basic and primary reason for the growth of grants-in-aid, says Dr. Finer was 'the decline of agriculture and an unjust local tax system'.[2] In India, under the Reforms of 1919 land revenue became the mainstay of provincial finance. It is difficult to find what percentage of it was spent upon rural education, medical relief, sanita-

[1] Webb, op. cit, p. 24.
[2] Finer, op. cit., p. 429.

tion, building of roads and bridges and rural development in general. But the backward condition of rural areas, lack of proper facilities for education, medical relief and sanitation and the inadequate development of the country roads, all unmistakably prove that very little of it is returned to the people from whom it is taken. 'The land revenue in India', observed the Taxation Enquiry Committee, 'is still largely a direct impost levied almost solely for state purposes. Only a very small fraction of the tax collected from the cultivators is actually used for rural development, and the illiterate ryot is therefore unable to recognize the benefit which he derives from the direct tax he pays.'[1]

Hence in India grants-in-aid must, in the interests of a better distribution of the tax burden between different social classes, different sources of income and different localities, form an integral part of the financial system of the country. Nothing would do more to rehabiliate rural finances, relieve unjust and oppressive tax burdens and place local finance in its proper relation to state finance than a system of grants-in-aid.

Principles of Grants-in-Aid : Percentage Grants and Block Grants

The principles upon which grants should be distributed between the local authorities remain to be considered. One important conclusion may at once be stated. Lord Balfour of Burleigh was of opinion that 'the contribution given should bear some relation to the cost of national service.'[2] The local authorities may receive grants based upon a definite proportion of the expenditure of a service, or a block grant, *i.e.* a fixed grant of money without the reciprocal obligation of matching half or two-thirds of the cost of the service, as the case may be.

Percentage grants are easy to calculate and flexible in nature. They offer a powerful stimulus to some local authorities to increase their expenditure, as part of their expenditure will be borne by the higher authority. They can easily be controlled by the granting authority without undue interference with the autonomy of the local authorities. But the greatest defect of percentage grants, in a country where the economic conditions of different

[1] *Report of the Taxation Enquiry Committee* p. 79.

[2] *Royal Commission on Local Taxation,* Cmd. 638 (1901), Separate Recommendations of Lord Belfour of Burleigh, p. 71.

local authorities differ vastly, is that they perpetuate inequalities of tax burdens. The percentage which will provide rich areas with wasteful expenditure will not permit the minimum of civic service in poor areas.

A case for percentage grants is, however, sometimes made out on the ground that since local expenditure is voluntary, a local authority which fails to take the best advantage of the central authority is wilfully negligent of its duty and deserves no encouragement. The fallacy of such an argument is clearly shown in cases where the failure of the local authority to take such help is due not to its negligence but to its poverty. It is exactly for improving the efficiency of such local authorities that grants-in-aid are meant.

Lord Balfour of Burleigh in his separate note to the Royal Commission on Local Taxation (1901) advocated the system of block grants.[1] Such grants, said he, should be given for each service taken as a whole and some attempt should be made in the distribution of such grants to equalize the burden of local rates. The principles upon which the grants should be distributed between the local authorities should take into consideration the cost of the services assisted and the economy and efficiency shown in their administration. Further, with a view to equalize the burden of onerous rates between the ratepayers of different areas, such contributions should be based upon the principle of ability.

The system of grants-in-aid in India should be approached in the light of these principles. With vast inequalities of local resources and differences in economic conditions, a system of grants in-aid is the only practicable method of equalizing tax burdens and introducing the maximum efficiency in the administration of national services. The following general principles for the distribution of grants-in-aid may be classified:

(i) Grants should only be given for 'national' services.[2]

(ii) Grants should bear some relation to the expenditure upon such services. The amount granted to each local authority

[1] Ibid, p. 73.

[2] See (a) Grice, *National and Local Finance*, p. 326.
(b) Cmd. 638 (1901), pp. 73-85.

should depend upon the varying circumstances of each area. In no case should the grant exceed one-half of the total expenditure.

(iii) In order to minimize the inequality of tax burdens in the provision of national services, the distribution of grants should be so arranged that the poorer districts should be treated with greater liberality than the rich ones.

(iv) The State Government should be given extensive powers to withhold the grants if a certain degree of efficiency is not reached in their administration.

(v) In all cases the State Government should exercise effective control and supervision over the local authorities through an annual inspection and audit.

(vi) Grants should not be given for purposes which will cause an actual rise in the value of immoveable property of the residents of the local area.[1]

(vii) In order that the local authorities may be able to chalk out a programme of uniform development, grants should be fixed for a period of not less than five years. They should be subject to periodic revision after taking into consideration the improvements made by each local authority during the last period.[2]

Local Indebtedness: Conditions under which Local Authorities should Borrow

Another important problem affecting the financial relations of local authorities and State Governments is that of local indebtedness. Local debts in the case of western countries have become a common feature of local finance.[3] The expensive character of the activities of local authorities, especially in the field of improvement of means of communication, sanitation, education, clearing of slums and other social services, has made it impossible for them to balance their budgets with taxation alone.

[1] See Professor Cannan's distinction between 'onerous' and 'beneficial' services. 'Beneficial' services are those 'which cause an actual rise in the value of immovable property.'

[2] For the principles of local finance see ch.i.

[3] See Grice, op. cit., ch.xx.

Large amounts of money are borrowed to finance such development activities.

In India the problems of local indebtedness, except in the case of the Corporations, have not so far come into prominence. But with the growth in the activities of local authorities, local indebtedness is bound to play a greater rôle in local finance. Hence it may be worthwhile to lay down certain principles which the State Government should take into consideration in regulating and controlling the problem of local indebtedness. These may be stated as follows :

(i) Loans should not be allowed to balance budgets. To avoid the unpopularity of increased taxation local authorities might sometimes resort to the easier method of balancing the budgets through loans. Such a practice would place a heavier burden on future taxpayers.

(ii) Loans should only be permitted for projects of real and permanent improvements which cannot be financed out of ordinary revenues.

(iii) Municipalities and district boards, in the interests of general financial security, should not be allowed to raise loans independently. Each loan application should be made to the loan department of the State Government. The purpose of the loan, the rate of interest, must all be definitely stated in the loan application.

(iv) Provision should be made for a sinking fund.

(v) If the loan is required for productive works the income from such works should be set apart from the general budget and should be utilized for the repayment of capital. In other cases provision for the repayment of capital must be made out of the general budget through increased taxation.

(vi) The State Governments should always balance the interests of the present and future generation of taxpayers. It is in the adjustment of the burden betwen the present and the future that the function of the central authority, says Dr Grice, as the preserver of financial honesty, the alleviation of immediate hardship and the guardian of the interests of future citizens is brought into play.[1]

[1] Grice, op. cit., p. 329.

(vii) Except in the case of Corporations, the State Governments should directly advance loans to local authorities. Instead of advancing from the state revenues, the State Governments should start a Local Authorities Loan Account and loans should be made out of this account. Such a system would have several advantages. It would keep the state revenues separate from local debts. It would restrict, control and keep down local debts. The legislative and administrative regulations made in connexion with the Local Authorities Loan Account would provide safeguards against vast borrowing by local authorities. It would not disturb the general rate of interest. Lastly, it would enable the local authorities to borrow easily and cheaply.

Conclusions

The changed basis of financial relationship between the State Governments and local authorities outlined in the course of this chapter would fill an important gap in the financial system of the country. In the place of the present uncontrolled and un-co-ordinated tax system resulting in inequalities of tax burdens, we should have a carefully adjusted system of local taxation in harmony with the national system of taxation. The need for such a change was never so urgent as it is now. The increasing tax burden on trade and industries in recent times demands a more unified and controlled system of taxation than ever before. Moreover, since the same individual has to pay taxes to different tax authorities, central, state and local, it is essential that, if the tax burden is to be distributed on a more equitable basis, a greater element of uniformity should be introduced. A policy of functional re-allocation coupled with the system of grants-in-aid would introduce equity, economy and efficiency in local finance and administration.

CHAPTER XI

SUMMARY AND CONCLUSIONS

§1. *Tendencies in State Finance and Policy*

The scope of public finance in India, as in most other countries, expanded greatly during the second half of the nineteenth century. So long as the East India Company was engaged in war, the outlay for military purposes exceeded all other expenditure. The economic, social and cultural needs of the masses were largely neglected. After 1858 there were added to the strictly military functions of the company certain functions which grew out of the Government's famine policy, for example, the building of railways and construction of irrigation works. In course of time, particularly after the Viceroyalty of Lord Curzon (1899-1905), the Government aimed at a new economic policy and undertook many constructive economic and social services. Hence in addition to maintaining law and order the Government was charged with the responsibility of assisting actively with the agricultural, industrial and social development of the country.

After the Independence of the country the two main objectives of economic policy are : a better standard of life for the people and social justice. These principles are derived from the Directive Principles of State policy as embodied in the Constitution. These Principles envisage equality of opportunity, the right to work, the right to an adequate wage and a measure of social security for all citizens. A Welfare State is the avowed goal of our Constitution. To achieve this new order, the Five-Year Plan has been appointed. The Plan has to lay the foundation for the future economic pattern of the country.

The expansion of Governmental activity in India has affected the system of State finance in four distinct ways. *First,* the expansion of social, economic and cultural expenditures needed additional revenues. *Second,* to secure efficient and economical administration the necessity for a satisfactory distribution of func-

tions between the Government of India and the States became imperative. *Third,* with the re-allocation of functions the necessity for the adjustment of revenues to needs arose. *Fourth,* it was felt that additional revenues could only be raised by entrusting the State Governments with the responsibility for raising a portion of their revenues.

The history of State finance described in chapters ii, iii, iv and vi illustrates these four tendencies.

The increasing financial decentralization from 1870 till the passing of the Government of India Act 1935 is the product of these tendencies.

The Constitution has fundamentally changed the scope of federal finance in India. This change has been brought about as a result of the working of three forces, namely :—

(1) the removal of the constitutional limitations under which the financial system was working under the Act of 1935 ;

(2) the changes in the economic functions of the State ; and

(3) the economic unity of the country brought about by the integration of the former Indian States into the Union.[1]

The Indian Constitution is a centralised federal constitution. The financial character of the Constitution has made the Centre definitely stronger than it was even under the Act of 1935. Perhaps this was necessary under the new political set-up of the country to check the working of separatist tendencies. The States, in view of their limited resources, must always look forward to the Centre for financial aid and thus will be following the dictation of the Union in all important financial and political matters.

The most remarkable tendencies in Provincial finance during the Reforms period 1919-1935 may be summed up as the stagnation of revenues, rising expenditure and unbalanced budgets. Most Provincial Governments feverishly pursued the policy of attempting to balance their budgets at all costs. Most of them fought shy of increasing old tax rates or introducing new ones. A policy of rigorous economy was followed ; expenditure on public works was curtailed ; all salaries were reduced, and expenditure on education and social services was also cut.

[1] See my *Economic Aspects of the Indian Constitution* (Orient Longmans). *1952.* Chapter VII.

The obvious failure to take advantage of certain other sources of revenue, especially the taxation of agricultural incomes, death duties, or sales tax was partly responsible for the financial plight of the Provinces. The lack of capital expenditure for the promotion of the economic development of the country crippled the future finances of the Provinces. This timid negative policy of balancing the budgets resulted in decreasing the purchasing power of the people and stagnation of revenue.

The recent fiscal policy of the Government is in contrast to that followed prior to Independence, when normal policy was one of maintaining a balanced budget with a low rate of spending and light taxes.[1] This new policy resulted in the buoyancy of revenues of the Government of India which, despite increasing expenditures, has resulted in surpluses in the revenue part of the budget of Rs. 50.84 crores, Rs. 33.27 crores, Rs. 59.22 crores, Rs. 92.61 crores and Rs. 3.73 crores in 1948-49, 1949-50, 1950-51, 1951-52 (revised) and 1952-53 (budget) respectively. The revenue surpluses have helped to finance part of the capital expenditure. Similarly, the total revenue of the Part A States has increased from Rs. 79.42 crores in 1938-39 to Rs. 314.82 crores in 1952-53 (budget). The total revenue of the Centre, Part A States and Part B States for 1952-53 is Rs. 831.89 crores.

Perhaps the most striking change in the fiscal policy of the Government has been the change both in the magnitude and the pattern of expenditure in the public sector. With the launching of the Five-Year Plan the total expenditure on development and/or refugee rehabilitation, incurred by the Central Government and Railways and Governments of Part A and B States during the year 1950-51, 1951-52 and 1952-53 are Rs. 303 crores, 382 crores and Rs. 445 crores respectively. In Part A States provision made for capital outlay outside the Revenue Account for 1952-53 is Rs. 129.80 crores or Rs. 24.58 crores and Rs. 68.31 crores more than in 1951-52 (revised) and 1950-51 (accounts) respectively. The major items include multi-purpose river valley projects, irrigation, electricity, housing and other civil works, industrial development and compensation to landlords.

[1] See *Public Finance Surveys India* (United Nations, New York) 1951 by Mrs. Ursula K. Hicks p. 101.

Besides much expenditure has also been incurred to improve agriculture and the economic condition of cultivators. The State agricultural departments have introduced improved types and varieties of crops and improved methods of cultivation. The co-operative movement has been strengthened and great assistance has been rendered to the cultivators in relief of indebtedness. The facilities for education have been increased. Efforts have been made to provide better medical aid, and the State Governments are largely responsible for improvements in public health and sanitation. But all these have merely touched the fringe of the problems. A more vigorous policy is needed to emancipate the poverty-stricken millions of India from an undernourished and disease-ridden existence. Is it possible? Can India sustain the burden?

§2. *Fundamental Obstacles to the Development*

State finance after Independence has entered a new stage. But the fundamental obstacles to the development of social services have remained unchanged. Hence the intensity and difficulty of the problems of public finance has also not changed. I am convinced that no change in the system of allocation of resources between the Centre and States, retrenchment and search for new taxes can result in a rapid advancement of the conditions of the life of the people unless certain fundamental obstacles are removed. Three such obstacles occur to me.

In Chapter I an idea of the size and population of India was given. The task of a Government in face of the vastness of the area, teeming population, its predominantly rural character and its dependence on the monsoon, and mass illiteracy, is particularly difficult. Hence financial stringency has been the universal complaint of the States and it has seriously hindered the pursuit of a more constructive social or economic development policy. My own conclusion is that a rapid advancement in the economic or social life of India, through any system of public finance or system of Government, is not possible unless the torrential increase in population is stopped. My assertion is supported by Dr. Anstey's observation, that 'it must be definitely recognized

that general prosperity in India can never be rapidly or substantially increased so long as any increase in the income of individuals is absorbed not by a rise in the standard of life, but by an increase in the population.'[1] *Second,* the power of the Government in India is overrated. Owing to the absence of the spirit for social services in India all schemes for social and cultural development must always come from the Government. The Government of a country, however, strong its finances may be, must necessarily find it a heavy task to inaugurate rapid social uplift. Perhaps if the national leaders now direct their attention towards social work many of India's most pressing present-day economic and social problems would be solved. In most other countries the task of social reform services is at least in part deliberately assumed by the people themselves. Therefore it can be concluded that unless the people assume at least part of the responsibility for finding solutions for a more extensive development of social services, reform must necessarily be slow.

Thirdly, the proper place and functions of local authorities in the national tax-system have not been realized. The local authorities have not developed their financial resources and have not undertaken responsibility for the organization and development of social services. Instead of using local resources for the provision and improvement of education, public health and medical relief or the improvement of rural and urban means of transportation, we have depended upon our state revenues. We reformed and expanded our provincial tax-system, leaving the local taxes as they were, and upon this flimsy foundation we wanted to build a programme for the reorganization and expansion of social services. As a consequence, lack of local initiative has been one of the major forces retarding the progress of social services.

§3. *Possible Lines of Progress*

Coming to the most desirable lines of progress in State finance it may be mentioned that, in spite of the development of large-scale industries and foreign and internal trade, over two-thirds of the people still depend upon agriculture, so that the

[1] Anstey, op. cit., p. 474. See ch. i.

relations between the State, the landlords and the tenants need urgent revision. No single factor in public finance, whether a change in commercial or tariff policy, or encouragement and organization of large/or small-scale industries, can compare in importance with the revision of land policy. I must emphasize here that abolition of zamindari alone would not improve the condition of the peasantry. Security of tenure and freedom to cultivate without restrictions and harassment from the State are no less important for the prosperity of the cultivators.

In conclusion it can be said that the future of State finance depends not only upon the discovery of new taxes, and inauguration of particular schemes of development or new lines of policy, but in the main upon fundamental social reforms and reorganization, directed towards controlling the size of the population, breaking up the existing over-rigid social stratification, stimulating enterprise and energy, promoting education and replacing the forms by the spirit of religion. It is thus and thus only that State finance can be utilized as an engine to help in providing for the hunger-stricken millions of India a decent existence in an unkind world.

Another line of progress to which attention has been drawn in Chapter X is the need for financial co-ordination between the State Governments and local authorities. The time has passed when it was possible to treat the problems of State and local finances in isolation. Today, the slender resources of the States and local authorities must be carefully husbanded if in the end budgets are to be balanced. It is only by pooling the resources of the States as a whole that the inequalities in the resources of poor areas can be minimized and an attempt can be made to reach a national minimum in the provision of essential social services. A carefully planned financial system and a thorough-going reorganization of State and local finances appears to be the most desirable line of progress to stimulate education and provide better medical and public health services.

Perhaps one of the most important needs of the day is the control over expenditure. There is a popular feeling that the Government is not exercising proper care in controlling expenditure

and the disbursing officers do not sometimes follow the prescribed rules of accounts. Be as it may, the fact remains that the audit reports point out numerous instances regarding financial irregularities. The long list of cases usually given in each year's audit report indicates that there is considerable room for improvement in the standards of control in some departments.

It is easy to lay down rules of expenditure ; it is very difficult to see that the disbursing officers are properly spending public revenues. The following general principles which have for long been recognised should be strictly followed by all Government officers spending public revenues :

(1) that the expenditure is not *prima facie* more than the occasion demands, and that every Government servant exercises the same vigilance in respect of expenditure incurred from public moneys as a person of ordinary prudence would exercise in respect of expenditure of his own money.

(2) that no authority exercises its powers of sanctioning expenditure to pass an order which will be directly or indirectly to its own advantage.

(3) that public moneys are not utilised for the benefit of a particular person or section of the community.

To control public expenditure eternal vigilance by the legislature and the Finance Department is absolutely necessary. The legislature through the proper functioning of the Estimates Committee and the Public Accounts Committee can exercise an effective control over the spending departments of the Government. The British Parliamentary Committee on Estimates has been performing a useful function in examining public expenditure. 'The Committee on Estimates constitutes the best parliamentary check on inefficiency in the Public Services yet devised in the United Kingdom.'[1] Again, the Public Accounts Committee of the British Parliament minutely examines public expenditure after the accounts have been audited and reported on by the Comptroller and Auditor General. The Chairman of the Public Accounts Committee is a member of the Opposition and the party balance of the Parliament as a whole is reflected in it. The

[1] Mrs. Hicks op. cit., p. 17-18.

double check acts as a highly efficient control against inefficiency and faulty planning.[1] At the Centre the Public Accounts Committee (consisting of fifteen members) and the Estimates Committee (with twenty-five members) are doing good work in exercising some control over public expenditure. Similar committees have been constituted in some of the States, but in most cases the members of the legislature, through these committees, do not exercise effective control over public expenditure. In Part B States there is still much leeway to make up in this and in other respects.

The control of the Ministry of Finance over the spending departments needs still further improvement. The Finance Minister should act towards the estimates of the spending department as *advocatus diaboli*. As the guardian of the people's purse and as the man who will have to find the money, it is for him to see that no service is included that is not essential, and that every service that is included is provided for in the most economical manner.[2] The Finance Minister should be the watchdog of economy.

Finally, to increase the efficiency check on expenditure at the administrative level, the establishment of Organization and Method Departments in all the departments on the British lines has become absolutely necessary. The Organization and Method Departmental officers should work in liaison with an organization and method service in the Ministry of Finance.

All possible economics should be made in public expenditure and extravagance and waste should be reduced to a minimum.

In conclusion, it may be said that the financial position of the Government of India and the States is sound. The nation has survived the unusual financial difficulties in the post-partition period. The keynote of the fiscal policy of the Government since 1947 has been high Government outlay on development together with high taxation. Since the Government is determined not to embark on a course of deficit financing high taxation must remain the normal feature of Indian fiscal policy for years to come.

[1] Mrs. Hicks op. cit., p. 17.

[2] Hilton Young, E. *The National System of Finance* (1936) pp. 22-23.

The finances of the country have been very well managed through the conservative monetary policy followed by the Reserve Bank of India which acts as the guardian alike of the State and Central finances. Under the financial leadership of Mr. Chintaman D. Deshmukh confidence in the Government's ability to steer the country through its present difficulties is evident in the rapid economic development of the country.

APPENDIX I

SOME PRINCIPLES OF TAXATION

In this Appendix we propose to discuss briefly some of the important principles in the pure theory of public finance. Although there is no country in which the whole system of taxation is one logically worked out from first principles.[1] yet it can hardly be denied that a knowledge of the leading principles of taxation would greatly help practical financiers in tackling the problems of public finance in a scientific spirit. Hence an examination of some of the principles may not be out of place here.

Benefit Theory of Taxation[2]

Historically, the benefit and ability theories of taxation have led to the introduction of proportional and progressive taxation. The benefit principle of taxation was based on the protection which the individual enjoyed under the State. Since protection was regarded as the chief function of the State, taxes were regarded as insurance premiums which an individual paid to the State for the security of life and property. From this was derived the theory of proportional taxation. In the beginning the theory of proportional taxation was rigid, proportional taxation being taken to mean proportional to income, irrespective of the size of the income. This conception was soon modified by the idea that income below a certain minimum should be exempt. The conception of the minimum of subsistence led to the introduction of the principle of degression in taxation.

The benefit theory is open to two main objections. *First*, if each person is required to contribute to the State in proportion to the benefit derived by him, two important questions arise : What *are* the benefits derived by him? and, *How* can they be measured? The *measurement* of benefits (for example, defence)

[1] Lord Stamp, op. cit., p. 24.

[2] For a discussion of the 'Ability' and 'Benefit' theories of taxation, see Seligman, *Progressive Taxation in Theory and Practice* (1908).

and their evaluation are problems not easy to solve. *Secondly*, even if it were possible to overcome this difficulty, the benefit principle would result in gross inequalities of tax burdens, for social expenditure (for example, elementary education) confers much more benefit on poorer people than on those who are better off. If this principle were strictly applied, many social services which benefit mainly the poorer classes would have to be forgone, as the necessary revenue could not be raised by taxation of those classes. But it is socially necessary and advantageous to provide such services. The principle, therefore, breaks down in practical application.

Nevertheless, the benefit principle has wide application in certain fields of public finance. The principle comes into play under betterment schemes, fees and local taxation. The Government often does things, in a business capacity, which could equally be performed by private enterprise. The public utility services render a special service to individuals which demand a payment in return. Such payments, called fees or prices, for public services sometimes contain an element of taxation.[1]

Ability Theory of Taxation

With the change in the functions of the State the benefit theory proved to be unsatisfactory. In a well-known passage of the *Wealth of Nations*, Adam Smith has set forth the functions of the State. According to him the Sovereign has only three duties to attend to: *first*, the duty of protecting the society from the violence and invasion of other independent societies; *secondly*, the duty of protecting as far as possible every member of the society from the injustice or oppression of every other member of it, or the duty of establishing an exact administration of justice; and *thirdly*, the duty of erecting and maintaining certain public works and certain public institutions which it can never be for the interest of any individual or small number of individuals to erect and maintain.

To provide funds for the State to perform these functions Adam Smith enunciated the four celebrated maxims of taxation,

[1] See chs. viii and xii.

briefly known as the maxims of Ability, Certainty, Convenience and Economy. The maxim of ability is a principle of taxation, the three others are administrative rules respecting taxes. The maxim of ability runs as follows :

> The subjects of every State ought to contribute towards the support of the Government as nearly as possible in proportion to their respective abilities, i.e. in proportion to the revenue which they respectively enjoy under the protection of the State.

The principle of ability led to progressive taxation.

The Principle of Minimum Sacrifice

The Smithian principle of ability has been differently interpreted. Property or income or both are selected as the tests of the taxpayer's ability. These are objective standards. John Stuart Mill transformed the objective standard into the subjective measure of 'sacrifice'. 'Equality of taxation', maintained Mill, 'as a maxim of politics means equality of sacrifice.'[1] The ability of the individual to pay taxes was measured by that proportion of his income the loss of which would impose upon him an equal sacrifice as compared with his neighbour.

The doctrine of equality of sacrifice was reinvigorated by Professor Edgeworth, who dropped the conception of equal sacrifice and introduced the idea of minimum sacrifice. 'The use of minimum', he says, 'instead of equal sacrifice enables us to pierce the sort of metaphysical mist which has been raised by the question: Why should the principle be adopted? The question is not embarrassing to those who regard minimum sacrifice as a deduction from the greatest happiness principle which can guide legislation on a great scale.'[2]

Following Edgeworth, Professor Pigou discards Sidgwick's principle of equity—the principle that similar and similarly situated persons ought to be treated equally—in favour of the principle of least sacrifice. He declares that 'we may properly

1 Mill, John Stuart, *Principles of Political Economy*. Bk. V, ch. ii, section 2.

2 *Economic Journal*, 1897, p. 566.

assert that least aggregate sacrifice is the one ultimate principle of taxation'.[1]

The principle of least sacrifice is based on the principle of diminishing marginal utility, which tells us that the utility of money decreases with its further increases to its possessor. The abstraction of Re. 1 from Rs. 10,000 will not inflict the same sacrifice as is abstraction from Rs. 100. Thus concludes Professor Pigou :

> In order to secure least aggregate sacrifice taxes should be so distributed that the marginal utility of the money paid in taxation is equal to all the payers. If the utility of the last penny paid by A were less than that of the last paid by B, a reduction of sacrifice could be secured by transferring a part of B's assessment to the shoulders of A. Thus, the distribution of taxation required to conform to the principle of least aggregate sacrifice is that which makes the *marginal*—not the total—sacrifices borne by all the members of any community equal.[2]

The principle of least aggregate sacrifice carried to its logical conclusion would involve lopping off the tops of all incomes above the minimum income and leaving everybody, after taxation, with equal incomes.[3]

On theoretical grounds the principle of least sacrifice is not much open to criticism. In its practical application to the logical conclusion, as stated above, the principle involves three important considerations, namely:

(i) Its effects on the distribution of wealth.
(ii) Its effects on production, and
(iii) Political practicability.

The lopping of all incomes above the minimum income assumes the complete powers of the State to redistribute wealth, so as to rectify inequality of fortune. Acting on this principle, if we have to raise Rs. 500 crores for State expenditure, we should lop off the top Rs. 500 crores of individuals' incomes until we have the amount. This may result in cutting down all incomes to,

[1] Pigou, A. C., *A Study in Public Finance*, 1929, pp. 60, 61.
[2] Pigou, op. cit., pp. 75-6. [3] Ibid., p. 70.

say, Rs. 2,000, below which none would pay taxation. Suppose, having cut down all incomes to Rs. 2,000, the State needs another Rs. 100 crores, on the principle of least sacrifice incomes between Rs. 1,500 and Rs. 2,000 will again be entrenched upon, and all incomes may be further reduced to less than Rs. 1,500.

The economic consequences of the principle to the dynamic life of the community would be disastrous.[1] The incentive to saving and enterprise would be lowered and the accumulation of capital would be retarded. For why should an industrialist, when incomes are to be cut down to Rs. 1,500, use his powers or exert special abilities to make Rs. 20,000 or a higher amount? If accumulation of capital has any value in the social and economic progress of a nation, the principle of least sacrifice, carried to its logical conclusion, would ultimately make the nation poorer.

Moreover, it is not only accumulation of capital which would be prevented, but private individuals would hesitate to take risks or to launch new enterprises. Thus inventions and improvements which are essential to the progress of society would be hindered.

Hence, supporters of this principle may reach very different practical conclusions according to the amount of weight assigned to these two aspects of the principle. One may like to diminish inequality of incomes and may give a greater weight to the distributional aspect of the principle. Another may wish to maintain the productive system in a certain form and may thus attach greater importance to the production aspect of the principle.

Moreover, the principle assumes the amount to be raised by taxation to be fixed. But the amount to be raised depends upon the activities of the Government.

Lord Stamp rightly observes that the application of least sacrifice in progressive taxation to rectify inequalities in distribution is partly illogical and considerably overemphasized, and if given pre-eminence is misleading and dangerous.[2]

Equilibrium Approach in Public Finance

The work of the great Italian economist, Antomio De Viti de Marco, is an attempt to study public finance from an equilibrium approach. His main thesis is that the phenomena of

[1] Lord Stamp, op. cit., p. 186. [2] Ibid., p. 188.

public finance represent an integral part of general economic phenomena.[1]

In Economics we study the activities of an individual directed towards the satisfaction of individual wants. The production of economic goods in a given quantity at a given time represents the general economic problem. In public finance we study the activities of the State directed towards the satisfaction of collective wants through the production of public goods.

Starting from this analogy between the phenomena of economics and public finance, De Viti proceeds upon the assumption that just as an individual is dominated in his actions by the attempt to maximize the satisfaction derived from his economic activities, so the members of a State desire that 'public goods shall be produced according to the law of least cost—because the lower the cost, the smaller will be their tax burden.'[2]

It is upon this foundation that De Viti builds his pure theory of public finance. He transfers the theory of value to public finance. He investigates the conditions 'to which the productive activity of the State must be subjected in order that *the choice of public services which are to be produced, the administration of their respective amounts, the distribution of the cost among the consumers,* etc., may take place according to the principle of the theory of value.'[3] Such an approach to the science of public finance would result in the greatest satisfaction of collective needs with the least possible waste of the efforts and wealth of a community.

In the above analysis of production and consumption of public goods, instead of the individual, the State is the active subject, and in place of *individual* wants we have *collective* wants.

This forms the framework of De Viti's approach to public finance. A closer examination of the theory of the fee and tax shows how an equilibrium approach forms the foundation of a pure theory of public finance.

[1] A. De Viti de Marco, *First Principles of Public Finance* (1936), p. 52.
[2] Ibid., p. 35. [3] Ibid., p. 36.

'Special' and 'General' Public Services

The satisfaction of collective wants is the chief function of the State. Collective wants are satisfied through the production of public services which may be divided into two broad groups : (i) special public services and (ii) general public services. The criteria of division between special and general public services depend upon whether the supply of the service is 'technically divisible into saleable units' or not. Special public service must be capable of retail sale in any quantity and at any moment. General public services on account of their character are not capable of division into saleable units. This criterion gives rise to the phenomenon of the fee.[1]

The theory of the fee has been discussed in detail in chapter iv. There it has been pointed out that in the supply of these services an exchange relationship between the State and the individual is established. The State charges a 'public price' for a 'public service'. This price is called fee.

No exchange relationship can be established for the supply of general public services, e.g. the defence of the country. For such services the State levies a tax. A tax is a compulsory contribution demanded by the State for the supply of general public services consumed by an individual.

The fundamental distinction between a fee and a tax arises from the fact that in the case of the fee it is possible to distribute the cost of the special public services among the consumers according to the actual consumption of the service; while in the case of the tax this is not possible as the consumption of general public services is an indeterminate amount. The problem of public finance is to distribute the cost of the indivisible benefit of general public services among the members of the community. It is here that Dr. Benham develops the concept of 'neutrality' to explain the distribution of tax burden.

'Neutral' System of Taxation—An Ideal System

'A neutral system of taxation and public expenditure', observes Dr. Benham, 'is one which translates into effect the voluntary

[1] See ch. ix.

judgments and preferences of the citizens, whatever they may be.' In such a system of taxation 'the difficulties of defining ends, of weighing them, of considering other effects, are evaded by the simple process of accepting whatever decisions the citizens themselves make.'[1] The way to discover what a neutral system of taxation would be is to consider what would happen if instead of the State performing certain services they were collectively performed by a group of men.

One can conceive of the existence of a group of men in a small area without a State. In this isolated society an individual will feel the need that his person and his goods should be defended against external attack or against the other members of his group. The community may provide an army or guards. Later on, to solve the disputes between him and other members, the community may provide law and order. The benefit from these services is indivisible. If we assume that each individual of such a community has equal income and tastes, each person, in these circumstances, might agree to contribute an equal amount towards the collective provision of such services provided that all his fellows did the same. Offenders who failed to pay the contribution would be penalized. The taxation in such a case would reflect the voluntary judgments and preferences of individuals and would be neutral. There would be no force as each member might deem it to his advantage to restrict his freedom of expenditure as all his fellows were doing the same.

But with the development of economic, ethical and political ties need will be felt for other services, for example road construction and maintenance, public instruction, supply of water, etc. The benefit of these services is divisible. Suppose these services are sold by private entrepreneurs who charge from each consumer a price corresponding to the amount of the service consumed, for example providing roads and charging tolls. But the inconvenience of frequent stoppages would soon lead the people to think that it is better to have free roads and to meet the cost by taxation.

[1] Benham, F., 'Notes on the Pure Theory of Public Finance', *Economica*, November 1934, p. 445. All page references are to this.

The coming of the State for providing these services 'will introduce no disturbing force. Each person will prefer the new situation to the old one. And it will be noted that all this involves no interpersonal comparison or addition of utilities, such as is sometimes implied in the concept of "collective wants". Each acts according to his own preference.'[1]

Now if we discard the conception of equal incomes and tastes, the new situation will make no difference in our analysis. Different persons will demand the collective wants in different amounts. But 'men with equal tastes', says Benham, 'may be prepared to pay different amounts towards a collective service because their incomes are different. Similarly with men of equal incomes whose tastes, including those arising from their different locations or occupations, are different. For *the amount of collective expenditure which a person desires will vary with the proportion of the total cost which he has to pay.*'[2]

Dr. Benham makes the above statement on the presumption that all the members in the community consume collective services. This corresponds with reality. Everybody derives benefit from the State protection of life and property. Everybody shares in the indivisible benefits of general public services. Those who disclaim these benefits (and consequently refuse tax payments) are in De Viti de Marco's words a pathological group against which the society must defend itself.[3]

It is on the above lines that Dr. Benham develops his theory of neutrality in taxation. This theory assumes that the various

[1] Benham, op. cit., p. 452.

[2] Benham, op. cit. p. 453. To the above analysis it may be objected that as *the consumption of general public services is not proportional to the income of each citizen,* the principle of neutrality breaks down. A little reflection, however, will show that this is not the case. Since income is the best single measure of judging the ability of an individual to consume general public services, we may justify our presumption by saying that if group 1 demands and consumes twice as much public services as compared with group 2, it is merely because the income of group 1 is twice as much as that of group 2. It is quite likely that group 1 may not consume, at a given moment, services on objects, say A and B, and group 2 on objects C and D. But in a long period of time, for example, a generation, difference of the total consumption of public services between groups 1 and 2 will diminish or disappear.

[3] De Viti, op. cit., p. 114.

preferences of citizens are 'correctly mirrored by their representatives in Parliament'. It is based on democratic Government. 'Periodical elections, constant criticism from the Press and organized groups, the habit of making concessions to minorities, usually ensures that no substantial body of opinion is for long in sharp disagreement with the whole system of public finance which prevails.'[1]

The conclusions of this analysis are in no way vitiated by objections like: What about benefits to persons suffering from sickness, unemployment or old age? Men who are not able-bodied can be helped either by voluntary aid or by special State provision; for example the State might for the sake of society as a whole, and with general consent, (i) exempt from taxation incomes below a certain level, and (ii) assist from general taxation those whose incomes do not reach the minimum subsistence level. There is nothing in the concept of neutrality to exclude what Dr. Benham calls a 'social conscience'. Moreover, when the incomes and tastes of individuals differ, the State, as pointed out previously, can follw a policy of discrimination in charging different prices to different people for special public services.

Despite the fact that no completely neutral system of public finance exists or ever existed, the conclusion cannot be avoided that this concept of neutral taxation is one of the most eloquent contributions in the pure theory of public finance.

The Best Tax Scheme

Having discussed the ideal tax system from a theoretical point of view, let us work out a tax scheme which may be best in practical application. The object of such a scheme should be to increase the prosperity of a nation. 'Prosperity', says Dr. Benham, 'is the state or condition of being more or less "well-off" in a strictly *material* sense.'[2] There are innumerable factors which influence the prosperity of a nation. Thus climatic conditions (especially rainfall in the case of India), natural resources, industrial and agricultural development, transport facilities, monetary and bank-

1 Benham, op. cit., p. 455.

2 Benham, F., *The Prosperity of Australia* (1930), p. 1.

ing policy, the machinery of public finance, the system of government, education, health and a hundred other factors may influence the prosperity of a nation. A discussion of all these factors is beyond the scope of this work. Hence we shall try to show how the prosperity of a nation is influenced through the machinery of public finance.

The system of public finance can influence the prosperity of a nation essentially in two ways: (i) reducing inequality of incomes, and (ii) influencing the system of production. The mode in which the national income is distributed among the members of the community affects prosperity. It is often the case that while the total national income is great, the way in which it is shared out is not even. Thus a small percentage of the income-receiving population may take a large proportion of the total, whilst a large percentage may receive a small proportion. The general opinion of economists is that 'whilst some inequality is both desirable and inevitable, *great* inequality is a waste of material welfare'. Thus public finance can increase prosperity by altering the unevenness which usually prevails in the distribution of national income.

Public finance also affects the system of production in a country. It may injure future production. The tariff policy of a country may result in a diversion of labour and capital from more profitable employments to less profitable employments. A high rate of income-tax may lead to some diminution in the growth of capital. The tax system may encourage the growth of monopolies. On the other hand, a well-operated system of public finance may increase the volume of production with the result that the increased size of national income may, on an average, give a larger share to each member of the community.

Thus the best system of taxation to increase the prosperity of a nation should increase its volume of production as well as secure a better distribution of national income. As stated previously, since taxation in practice represents practical compromise no scheme of taxation can secure absolute scientific precision in the application of the above two principles. To every tax-system ob-

[1] Benham, op. cit., p. 11.

jections can be raised; our object is to indicate a well-balanced system, coming nearest to the realization of the above two principles, which is least objectionable and most effective.

Reducing Inequality of Incomes

The problem of reducing the inequality of incomes raises four questions: (i) *Why* should the State reduce the inequality of incomes? (ii) To what *extent* should the inequality be removed? (iii) In what *way* can the inequality be minimized? and (iv) What *machinery* should be employed to reduce inequality? We shall consider each of these questions in turn.

'Taxation for revenue only' was a Victorian slogan of public finance. Taxation for objects other than revenue was considered impolitic or wrong. The common opinion was that it was no part of the duty of the State to 'readjust the vicissitudes of fortune'. But public opinion of late has changed, and taxation now is justified as an engine for redistribution of wealth. The reason for this, to use the words of Dr Benham, is that 'since prosperity is, ultimately, a state or condition, a given national income would "go further" if it were *somewhat* less unevenly distributed than is often the case in modern communities.'[1] Hence taxation in modern States is not always swayed by revenue considerations. The State, to increase the prosperity of the nation, aims at a more equitable distribution of wealth.

This change in attitude towards taxation is primarily due to the enlarged conception of 'equity'. 'Equity', Professor Marshall says, as 'an adequate guide in the philosophy of taxation', was based on the principle of *existing rights;* 'it was generally considered equitable that everyone should contribute' on the joint-stock plan to the expenses of the State. So that, if taxation aimed at redistribution of wealth it was manifestly wrong and unjustifiable. This conception later on was changed, and it was generally recognized, to quote Professor Marshall again, that 'though a joint-stock company must accept them [existing rights] as final, the State is under obligation to go behind them; to inquire which of them are based on convention or accident rather than fundamental moral principle;

1 Benham, op. cit., p. 11.

and to use its powers for promoting such economic and social adjustments as will make for the well-being of the people at large.'[1]

A National Minimum Income

This brings us to the second question. To what extent should the State reduce inequality of incomes? Here we are at once faced with a difficulty. On the question of what ought to be the functions of the State people may differ. For this is a matter of opinion, and economic analysis cannot prove that one opinion is right and another wrong. A socialist may advocate complete equality of incomes to achieve a social millennium. But there is grave danger that drastic changes in the redistribution of income may check economic progress and may curtail the volume of production per head. Hence we think it desirable to state (to avoid these controversial matters) that within the framework of capitalism the State should try to achieve the ideal of providing every citizen with a national minimum real income.

Before stating how to achieve this, it is desirable to signify what precisely is meant by a national minimum standard of real income. 'It must be conceived' says Professor Pigou, 'not as a subjective minimum of satisfaction, but as an objective minimum of conditions. The conditions, too, must be conditions, not in respect of one aspect of life only, but in general.'[2] The determinants of a national minimum income have been stated by Dr. Benham under four heads. Briefly they are :

(i) The provision of adequate food, clothing, medical attention, education and other essentials, for all *children*. (This would reduce the influence of environment and opportunity in causing the differences in earnings which explains, to some extent, the gulf between the haves and the have-nots.)

(ii) The removal of the haunting shadow of *insecurity* which darkens many lives.

[1] Marshall, Alfred, *National Taxation after the War.* This forms chapter xviii in *After War Problems,* edited by William Harbutt Dawson (1917), p. 317.

[2] Pigou, A. C., *The Economics of Welfare,* p. 714.

(iii) The reduction of *inequality* of incomes through the machinery of public finance.

(iv) The improvement of *productive capacity* through greater public expenditure, chiefly upon health (and especially preventive measures) and education.[1]

The provision of a national minimum income, taking all the above factors together, could be achieved by transferences of national income from the relatively rich to the relatively poor. A detailed discussion of these heads is clearly beyond the scope of a work on provincial finance in India. However, we shall indicate the different types of transferences effected in a modern State.

These transferences can be grouped under two heads; *first,* those which increase the income of the citizen directly. The transferences in the form of pensions, unemployment insurance, and poor relief, would come under this head. The tacit assumption underlying the State expenditure on education, health, medical, and similar services is based on the expectation that the poorer members of the community will derive greater benefit from these services than the rich. The transference of national income in the form of services in favour of the poor is a growing proportion of the national expenditure. But here there is one difficulty. In practice it is not possible to set up a standard which a person must satisfy before he is entitled to the benefit of these services. The result is that these services benefit equally different persons (rich and poor) whose circumstances are substantially different. Mrs. Hicks writes, for example: 'The extent to which the social services imply a redistribution of the national income from the richer to the poor part of the community naturally differs very much from one service to another, as it does from one country to another.'[2] In ideal conditions a separate standard capacity would be fixed for different groups into which the community may be classified. Thus, persons having a certain income alone should be entitled to use, say, education and medical services provided

[1] Benham, op. cit., pp. 240-1.

[2] Hicks, U. K., *The Finance of British Government,* 1920–36 (Oxford University Press) 1938, p. 56.

out of national income. The redistributive character of the plan would depend upon the skill of the classifying authorities, and the co-operation between the Government and the governed.

The Case for a Single Tax

Having indicated the reasons, the extent and the methods by which the State attempts to reduce inequality of incomes, we now turn to the most important field of our inquiry, namely, what machinery should the State employ to reduce inequality of incomes? This is the most complicated matter. The State in a great number of ways and for a great variety of reasons raises its revenue. Here we have to evolve a scheme which shall increase national prosperity. We have to discuss the problems of the distribution of taxation.

Some writers cherished the idea of a single tax on land values. The Physiocrats advocated a single tax 'on the net product of the soil'. Their argument is that since the amount of land is limited and the increment in the value of land is due to the 'progress of the society', a tax on land value justly belongs to the State and should pay all its expenses. The arguments against the single tax on land values are too well known and need not be repeated. Today, little is heard of this proposal.

This idea of a single tax on land values has been followed by proposals for a single tax on 'expenditure'; a single tax on 'capital'; a single tax on 'income', etc., etc. The most popular single tax that is discussed nowadays is the single tax on income. On this point I cannot do better than quote Dr. Benham's words: 'There is a much stronger theoretical case for a tax on income. For income is the best single measure of ability to pay, and if income alone were taxed, the Government would be able to decide exactly how much a man with a given income should pay. If it wished, it could exempt altogether incomes below a certain level, it could tax incomes from property more heavily than incomes from works, it could allow deduction for children, and so on.'[1]

If there were only an income-tax, a taxpayer, after paying the tax, would be at liberty to spend his income in whatever way

[1] Benham, op. cit., p. 305.

he chose. As it is, taxation of commodities penalizes the consumers who happen to use the taxed commodities as compared with those who do not. Thus the taxation of salt and sugar hits the income of a poorer man much more than that of a rich man. Such taxation cannot be 'progressive'; it is not even 'proportional' to the total incomes of the two; it is proportional to the amount spent by each over these objects. But as a man earning say Rs. 50, buys much more of the taxed commodities than the rich man, the former pays much more in taxation though he pays nothing in income-tax. A single tax on income would be free from all these defects.

Perhaps the greatest limitation to the proposal for a single tax on income is that it is not possible to ascertain the total income of every citizen. As Professor De Viti says: 'If a synthetic method were available for the ascertainment of the total income of every citizen with uniform results, the single tax would solve the problem of simplification. But the concrete problem resides precisely in making the hypothesis a reality.'[1] Moreover, if the income-tax were increased, and other taxes abolished, the burden upon the taxpayers may appear to be too heavy and may result in fraud and evasion. Income-tax, in Gladstone's words, was bad because it made a 'nation of liars'. Hence, a single tax on income, though theoretically sound, is on the grounds of 'workability' exposed to dangers. In this connexion the observation of Lord Stamp may be quoted with profit: 'It may be taken as axiomatic that the more closely the tax conforms to just principles the more open it will be to evasion, and the problem for the State is always how closely to conform to principle without giving up its safeguards.'[2]

From this we may conclude in order that no incomes escape taxation and the tax scheme be practicable, the single tax on income must be supplemented by other taxes. This is done in most modern States through a system of manifold taxes, which consists in the transformation of a single tax into various taxes. The system differentiates income into several sub-categories—as, for example, 'income spent', or 'income saved'; or again, income

1 De Viti, op. cit., p. 206. 2 Stamp, op. cit., p. 119.

from land, from capital, from trade and industry, from professions. For each type of income a different rate may be fixed; the object being to increase or decrease the tax burden on some classes of income as compared with others.

A Manifold Tax System

Differentiation is usually achieved by dividing the tax system into direct and indirect taxes. The criteria for distinguishing between these two types of taxes have given rise to much controversy, but need not detain us here. Each basis of distinction is open to some criticism. Thus John Stuart Mill's definition, to take only one example, of a direct tax as one 'demanded from the very persons who, it is intended, or desired, should pay it', and an indirect tax as one 'demanded from one person in the expectation and intention that he shall indemnify himself at the expense of another', does not always square with actual facts.[1]

Perhaps the best way to get out of these difficulties is to look at the division from the point of view of practical administration, which has reference to the method of *collection.* According to this criterion a direct tax is one which is levied at fixed intervals from persons whose names are known to the tax authorities. Indirect taxes are levied on the occasion of certain definite acts, which do not fall at fixed intervals and do not require the lists of names of taxpayers. An elaboration of this discussion is not relevant to our subject.

The main object of the introduction of direct and indirect taxes is to divide the taxpayer's fiscal obligation into several parts; part of which he must pay by direct taxes and part by indirect taxes. It is easy to show how a tax system, where both direct and indirect taxes exist side by side, is superior to one where only one of them exists. The outstanding problem is the distribution of the burden in reality on some principles. From what has been said before, it follows that the most important principle is to tax according to ability to pay. Indisputable as this principle is, in its practical application many difficult issues confront us. In measuring ability to pay we not only take certain objective attributes as

[1] Mill, *Principles of Political Economy,* p. 423.

indicia but also something which relates solely to the subjective side of human life. For example, the exemption of the minimum income from taxation is based on humanitarian as well as economic grounds. The really important question, therefore, before us is what tests should be applied to measure ability and what relative importance should be attached to each of them. Four such tests of ability readily occur to one. They are :

(i) Net income.
(ii) Net assets.
(iii) Expenditure.
(iv) Special ability.

We shall discuss each of these, one by one.

Tests of 'Ability' to Pay: (i) *'Income' as a Test of Ability*

It has been shown that *income* is the best single test of ability to pay. But as income sometimes depends on the assets of an individual, assets may be taken as the second test of ability.

Income is always measured over *a period of time;* a week, a month, or a year. It may arise from the labour of the worker himself (e.g. wages, salaries, fees); it may be due to the assets of the person (e.g. interest, rents, dividends) ; or lastly, it may arise as a result of State policy (e.g. pensions or unemployment allowances). Thus, an individual may receive income from either of the first two sources or both of them. Income arising from the third source is merely a redistribution of a portion of the national income raised through taxation among certain sections of the community.

Income as a test of ability may be taken to mean the *net receipts* of an individual from all sources during a given period of time. √Thus the business expenses of a manufacturer, or the cost of maintaining property, or other expenses to maintain capital intact, should be deducted before finding the net receipts available for taxation. Similarly, it is commonly recognized that to maintain human capital intact, a certain minimum expenditure on food, clothing, housing and other necessaries for efficiency should be exempted from taxation. In fact the income-tax law of practically every country exempts a certain minimum income from taxation.

It is important to remember, however, that before ability can properly be tested by net income, the factor of time should be taken into account. 'We are so used to considering income "by the year" that it seems to be almost an ordinance of nature.'[1] Yet income fluctuates from year to year. A tax system that does not take into consideration a proper unit of time for a particular type of income is bound to be inequitable. To take one example: the British income-tax differentiates against industries whose profits fluctuate over time as compared with those that are stable. This will appear from the following table :

YEAR	INCOME OF FIRM I	SURTAX	INCOME OF FIRM II	SURTAX
1	£2,000	0	£10,000	£1,519–7–6
2	£3,000	£61–17–6	,,	,,
3	£25,000	£6,469– 7–6	,,	,,
4	£4,000	£171–17–6	,,	,,
5	£16,000	£3,361–17–6	,,	,,
	£50,000	£10,065– 0–0	£50,000	£7,596–17–6

It is clear from the above table that firm I, whose income fluctuates from year to year, pays more in surtax than firm II during a period of five years.

It is not possible to suggest a definite period of time which may be suitable for all types of incomes. However, a three or five years' average system would give power to an individual to carry over his income. In an agricultural country, where agricultural conditions fluctuate from year to year, a five years' period would perhaps be suitable.

(ii) *Assets as a Test of Ability*

The assets of an individual at a certain point of time represent the market value of all his possessions, plus the value of the debts receivable by him and minus the value of the debts payable from him. The assets of an individual may be in various forms; they may range from stocks and shares, land and buildings. and hoarded money, to jewellery, ornaments and furniture.

[1] Stamp, op. cit., p. 27.

The assets of an individual are of less importance than his income as a test of ability. In the first place, a part of his assets cannot be taxed. A person who locks up Rs. 10,000 in diamonds escapes the payment of tax on that amount during his lifetime. Thus assets of the type of hoarded money (a common type in India), jewellery, ornaments, furniture or other non-income-yielding assets are outside the pale of taxation during a certain period of time. In the second place, the appraisal of the revenue-yield from assets is a matter of difficulty. No doubt in some cases the yield from the assets is deducted at the source; but in some cases, either through fraud or understatement, it escapes detection. Moreover, reappraisals of incomes from certain types of assets cannot be made as rapidly as the incomes vary. Thus, while the tax on land or buildings is fixed for long periods, the incomes vary meanwhile.

Nevertheless, assets are a useful test of ability on certain occasions. They give rise to the distinction between 'earned' and 'unearned' income. The reasons for giving favoured treatment to earned income depend upon the fact that its continuance depends upon the effort of the particular person. It stops when he ceases to work. Such a person has to make various personal and domestic allowances. The possession of capital thus affects 'ability to pay' in incomes. Taxes on capital transactions and transfers of property (in the shape of stamp duties) represent indirect taxes on savings and are justified on the score of assets as a test of ability. Finally, assets are a useful test of ability in death duties.

(iii) *Expenditure as a Test of Ability*

The first two tests of ability—net income and net assets—present few difficulties. Expenditure as a test of ability, in capitalistic countries with sharp inequalities in income and assets, creates differentiation in taxation. In the search for the exemption of savings from taxation, Professor Pigou considers the possibility of a general expenditure tax. 'If that part of income', says he, 'which is devoted to the purchase of consumable goods and services, as distinct from capital goods and services, is taxed, and the rest left untaxed, we shall obviously have a tax system under which

"spent" income is taxed and "saved" income exempted.'[1] Logically, an expenditure tax would exempt savings from taxation. Apart from the considerations whether the exemption of savings is desirable or not (to them we return in another section), the practical difficulties in the successful working of the tax rule it out of court. We have, therefore, to inquire whether it is desirable to have expenditure as a subsidiary test of ability without causing too much tax differentiation.

It is universally recognized that every individual, to realize that he is a citizen, must pay some tax towards the cost of the State. Direct taxation of the income of the poorer classes, even roughly to conform to the principle of ability, is difficult and troublesome. Its assessment and collection will need an army of collectors and may leave a wide door open for evasion and fraud. The administrative costs may ultimately be higher than receipts. Hence a tax on expenditure in the shape of indirect taxes is levied. Excise duties and customs are the most common examples of indirect taxes.

In addition to the administrative difficulties another reason for the levy of taxes on commodities is the practical one of plucking the goose with the least squealing. The tax is wrapped up in the price of a commodity and hence causes much less resentment among the taxpayers than would be caused by an equal amount raised through direct taxation.

Theoretically, it would be ideal to have a progressive expenditure tax; in it 'it would be necessary to impose upon each commodity, not a single rate, but a number of different rates adjusted to the incomes of the various purchasers.'[2] Such an arrangement, however, is practically impossible. Hence we have *ad valorem* or *specific duties*. Here difficulties arise. *Ad valorem* commodity taxes, though proportionate, are actually regressive; the ratio of the tax is different to different incomes. Thus, if everybody's expense on certain taxed articles were the same, irrespective of the size of their incomes, the rates of the taxes borne by them would vary inversely to the size of their incomes;

[1] Pigou, op. cit., p. 141.
[2] Pigou, op. cit., p. 142.

for example, if the tax is 1 pice in the rupee for an income of Rs. 1,000; it would be 2 pice in the rupee for an income of Rs. 500; 1 anna in the rupee for an income of Rs. 250; and 2 annas in the rupee for an income of Rs. 125.

There are, however, more serious objections than this Experience shows that the poor, as a class, by reason of family obligations, consume a larger quantity of lucrative revenue-yielders (*i.e.* necessaries of life than the rich, and, therefore, pay not only a higher rate of tax, but also absolutely more. Moreover, as most taxes in practice are *specific,* the poor pay more by consuming articles of an *inferior* quality.

There are many other defects of expenditure as a test of ability. Some might object to it as it does not take into account what Lord Stamp calls the 'domestic circumstances' of the tax-payer; others might say that it fails to do justice as it does not discriminate between earned and unearned incomes; still others might contend that as it does not tax net assets it is leaving out an important test of ability. But few would deny that as a supplementary test of ability *some* weight should be given to it. It is a minor test of ability. In practice, unfortunately, those who direct public affairs, through ignorance, party politics, national pride or vested interests, attach undue importance to expenditure taxes. Other considerations outweigh economic reasons. The result is that the tax system of the country becomes regressive instead of progressive. This ultimately must react on the prosperity of the nation. In such a case the most obvious remedy is to arouse the electorate to demand from the statesmen the course of policy which shall serve their interests best.

(iv) *Special Ability*

Net income, net assets and expenditure as tests of ability should be supplemented by special ability. Special ability should be applied in relation to the taxation of windfalls. By 'windfalls', Professor Pigou means 'accretions to the real value of peoples' property that are not foreseen by them and are not in any degree due to efforts made, intelligence exercised, risks borne, or capital invested by them.'[1] The special ability principle may be applied

1 Pigou, op. cit., p. 177.

in the case of both income and assets. Thus irregular or spasmodic receipts do not require the same sacrifice or efforts as does regular income, and possess a higher degree of ability. The taxation of the increment in land values due to the progress of society, or the excess profits earned during war time, or windfalls due to lotteries, fall under the special ability principle. Similarly, the taxation of big inheritances may also be looked at from this point of view.

As under the principle only extraordinary gains in income or capital would come under taxation, the principle as a test of ability is of minor importance. Nevertheless, it is peculiarly suitable for application on certain occasions.

The Tax System must be Progressive

Finally, progression must form the most prominent feature in the tax system of every country. The reduction of inequality of incomes is attempted through progression. Whether it is the taxation of income or assets, progression is universally applied. It is also of help in the application of the special ability principle. A rough approximation to progression is attempted in expenditure-taxes by taxing articles mainly consumed by the rich at higher rates than those consumed by the poor. We have placed progression last not because it is of least importance, but because it is the universal principle which should be applied in all the tests of ability. The arguments for this have been discussed in pages 304-6.

Income-Tax and Savings

Into the wider question how taxation affects the productive system in a country, it is not posible to enter here. As income forms the principal test of ability in the tax scheme described above, I shall briefly consider the disputed question whether an income-tax discriminates against savings or not.

There is no unanimity of opinion among economists on this point. Professor Pigou is of the opinion that a permanent general income-tax discriminates against savings. Professor Cannan, Dr. Benham, Professor De Viti and Lord Stamp put forward the

contrary view. Let us briefly state the main arguments of each view.

Professor Pigou contrasts the effects of a permanent expenditure-tax (*i.e.* a tax on consumed income) with a permanent general income-tax. He says: 'Under the former, resources that are saved are taxed indirectly, through their subsequent yield, to the same extent as resources that are consumed at once. There is, therefore, no differentiation of any kind. An income-tax, on the other hand, differentiates against saving, by striking savings both when they are made and also when they yield their fruits. Thus a general permanent income-tax at the rate of *x* per cent, strikes the part of income that is spent at this rate. But, if £100 of income is put away from saving, it removes £*x* from it at the moment and, thereafter, removes also some part of the fruits yielded by it.'[1] The opposite view has been plainly put by Lord Stamp. 'Let us assume that a man saves £100 and at the end of ten years has had £5 per annum, and still having his £100 he then spends it. He pays tax in all upon £150 either under the present system, when his tax is on the £100 at first and the £50 by annual instalments afterwards, or under an alternative system of taxation on expenditure, where he pays on £5 per year for ten years and £100 in the tenth.'[2]

Professor Pigou in the above view is mistaken in assuming that savings are never withdrawn for spending. For, as Dr. Benham has pointed out 'it can be urged that in order to make a complete comparison between the two taxes in question, we must consider the whole cycle—accumulation of capital, receipt and expenditure of interest, and withdrawal and expenditure of capital. It then seems that if an income-tax can be said to strike savings twice, so can a general expenditure-tax.' The former strikes them when they are made, and when interest on them is received, but not when they are withdrawn and spent. The latter does not strike them when they are made, but it does strike them both when interest on them is spent and when the savings are withdrawn and spent.'[3]

1 See Pigou, op. cit., p. 136; Benham, *Economica, November*, 1934; Stamp, op. cit., pp. 58-61. See also *Economic Journal,* 1935 (Sept.), Guillebaud's article on Income-Tax.

2 Stamp, op. cit., p. 60.

3 Benham, op. cit., p. 442.

The issue, perhaps, can be clarified by means of an arithmetical example. With 5 per cent rate of interest £100 saved will become £105 in a year. If there is no income-tax this will remain £105. If income-tax is 20 per cent, £100 saved will become only £104. Now suppose there is a sales tax of 20 per cent. £100 spent now are worth £80. £105 spent at the end of a year are worth £84.[1] Thus the terms of exchange are unaltered whether there is an income-tax or sales tax, for 80:84:: 100:105. Hence an income-tax on savings does not discriminate against savings.

Conclusion

Our brief survey of the broad characteristics of the scheme has demonstrated the possible ways in which the tax burden of a country may be distributed. But the practical difficulty remains. Various sets of weights may be assigned to each test. One set of weights may yield quite a different result from another. Moreover, the set of weights would differ between times and places. For each country various compromises may be possible. Clearly the differences in results in each compromise would reflect the effect of the weights assigned to each test. As time goes on the weights may have to be changed. For example, the real income of the population or the character of its distribution among the people may change. People may spend a larger proportion of their incomes on objects which formerly used to be considered as luxuries (for example, motor-cars, radios, expensive dresses, and so on). The sharp inequalities in income and property may change. This may give scope for commodity taxes to play a dominant part; for taxes on expenditure are less regressive when objects of taxation are luxuries or where a considerable majority of the members in a community are about equally wealthy. In times of war, when businessmen are making high windfall profits, the special ability test should be assigned a greater weight. The industrial revolution increased the total volume of production in England but created a wider gulf between haves and have-nots. The necessity for a heavier weight to net income was clearly visible

[1] It is assumed here that savings are withdrawn for spending and a tax is paid on them.

in those days. One conclusion which emerges from all this is that the practical application of the tests will differ between times and places; and the tax system, though largely dependent upon the tests indicated above, will be to some extent arbitrary.

Nevertheless, it may be stated that, to make the tax system of a country progressive, greater weight ought to be attached to direct taxes. Taxation of net income and net assets appears to be the most desirable lines of action. Thus income-tax, corporation tax, super-tax and death duties should be, among others, the most important sources of revenue for the State. To tax the incomes of the poor classes, so that everybody should contribute something towards the expenses of the State, indirect taxes should be imposed. Taxation of a few necessaries of life, through customs or excises, should form an important feature of the tax system. In selecting the necessaries of life it must always be kept in mind that unnecessary hardship must not be caused to the poorer classes. Taxation of luxuries should also be made to contribute a substantial portion of the revenues of the State.

In practice, to evolve a tax system free from all possible defects is almost an impossible task. For one thing taxation is a matter of expediency. For another no finance minister can suddenly break through the established tax system. Finally, it would be difficult to estimate exactly the incidence of each tax. Hence the aim of the finance minister should be to make the system progressive. The justice or injustice of the tax system essentially lies in whether it is progressive or regressive.

APPENDIX II

STATES OF INDIA

PART A

Names of States	Names of Corresponding Provinces
1. Assam	Assam
2. Bihar	Bihar
3. Bombay	Bombay
4. Madhya Pradesh	The Central Provinces and Berar
5. Madras	Madras
6. Orissa	Orissa
7. Punjab	East Punjab
8. Uttar Pradesh	The United Provinces
9. West Bengal	West Bengal

PART B

1. Hyderabad
2. Jammu and Kashmir
3. Madhya Bharat
4. Mysore
5. Patiala and East Punjab States Union
6. Rajasthan
7. Saurashtra
8. Travancore-Cochin
9. Vindhya Pradesh

PART C

1. Ajmer
2. Bhopal
3. Bilaspur
4. Cooch-Behar
5. Coorg
6. Delhi
7. Himachal Pradesh
8. Kutch
9. Manipur
10. Tripura

PART D

The Andaman and Nicobar Islands.

APPENDIX III

LEGISLATIVE LISTS

List I—Union List

1. Defence of India and every part thereof including preparation for defence and all such acts as may be conducive in times of war to its prosecution and after its termination to effective demobilisation.

2. Naval, military and air forces, any other armed forces of the Union.

3. Delimitation of cantonment areas, local self-government in such areas, the constitution and powers within such areas of cantonment authorities and the regulation of house accommodation (including the control of rents) in such areas.

4. Naval, military and air force works.

5. Arms, firearms, ammunition and explosives.

6. Atomic energy and mineral resources necessary for its production.

7. Industries declared by Parliament by law to be necessary for the purpose of defence or for the prosecution of war.

8. Central Bureau of Intelligence and Investigation.

9. Preventive detention for reasons connected with Defence, Foreign Affairs or the security of India; persons subjected to such detention.

10. Foreign Affairs; all matters which bring the Union into relation with any foreign country.

11. Diplomatic, consular and trade representation.

12. United Nations Organisation.

13. Participation in international conferences, associations and other bodies and implementing of decisions made thereat.

14. Entering into treaties and agreements with foreign countries and implementing of treaties, agreements and conventions with foreign countries.

15. War and peace.

16. Foreign jurisdiction.

17. Citizenship, naturalisation and aliens.

18. Extradition.

19. Admission into and emigration and expulsion from India; passports and visas.

20. Pilgrimages to places outside India.

21. Piracies and crimes committed on the high seas or in the air; offences against the law of nations committed on land or the high seas or in the air.

22. Railways.

23. Highways declared by or under law made by Parliament to be national highways.

24. Shipping and navigation on inland waterways, declared by Parliament by law to be national waterways, as regards mechanically propelled vessels; the rule of the road on such waterways.

25. Maritime shipping and navigation, including shipping and navigation on tidal waters; provision of education and training for the mercantile marine and regulation of such education and training provided by States and other agencies.

26. Lighthouses, including lightships, beacons and other provision for the safety of shipping and aircraft.

27. Ports declared by or under law made by Parliament or existing law to be major ports, including their delimitation, and the constitution and powers of port authorities therein.

28. Port quarantine, including hospitals connected therewith; seamen's and marine hospitals.

29. Airways; aircraft and air navigation; provision of aerodromes; regulation and organisation of air traffic and of aerodromes; provision for aeronautical education and training and regulation of such education and training provided by States and other agencies.

30. Carriage of passengers and goods by railway, sea or air by national waterways in mechanically propelled vessels.

31. Posts and telegraphs; telephones, wireless, broadcasting and other like forms of communication.

32. Property of the Union and the revenue therefrom, but as regards property situated in a State specified in Part A or Part B of the First Schedule subject to legislation by the State, save in so far as Parliament by law otherwise provides.

33. Acquisition or requisitioning of property for the purposes of the Union.

34. Courts of Wards for the Estates of Rulers of Indian States.

35. Public debt of the Union.

36. Currency, coinage and legal tender ; foreign exchange.

37. Foreign loans.

38. Reserve Bank of India.

39. Post Office Savings Bank.

40. Lotteries organised by the Government of India or the Government of a State.

41. Trade and commerce with foreign countries; import and export across customs frontiers; definition of customs frontiers.

42. Inter-state trade and commerce.

43. Incorporation, regulation and winding up of trading corporations, including banking, insurance and financial corporations but not including co-operative societies.

44. Incorporation, regulation and winding up of corporations, whether trading or not, with objects not confined to one State, but not including Universities.

45. Banking.

46. Bills of exchange, cheques, promissory notes and other like instruments.

47. Insurance.

48. Stock exchanges and future markets.

49. Patents, inventions and designs ; copyright ; trade marks and merchandise marks.

50. Establishment of standards of weight and measure.

51. Establishment of standards of quality for goods to be exported out of India or transported from one State to another.

52. Industries, the control of which by the Union is declared by Parliament by law to be expedient in the public interest.

53. Regulation and development of oilfields and mineral oil resources ; petroleum and petroleum products ; other liquids and substances declared by Parliament by law to be dangerously inflammable.

54. Regulation of mines and mineral development to the extent to which such regulation and development under the control of the Union is declared by Parliament by law to be expedient in the public interest.

55. Regulation of labour and safety in mines and oilfields.

56. Regulation and development of inter-state rivers and river valleys to the extent to which such regulation and development under the control of the Union is declared by Parliment by law to be expedient in the public interest.

57. Fishing and fisheries beyond territorial waters.

58. Manufacture, supply and distribution of salt by Union agencies, regulation and control of manufacture, supply and distribution of salt by other agencies.

59. Cultivation, manufacture and sale for export of opium.

60. Sanctioning of cinematograph films for exhibition.

61. Industrial disputes concerning Union employees.

62. The institutions known at the commencement of this Constitution as the National Library, the Indian Museum, the Imperial War Museum, the Victoria Memorial and the Indian War Memorial and any other like institution financed by the Government of India wholly or in part and declared by Parliament by law to be an institution of national importance.

63. The institutions known at the commencement of this Constitution as the Banaras Hindu University, the Aligarh Muslim University and the Delhi University, and any other institution declared by Parliament by law to be an institution of national importance.

64. Institutions for scientific or technical education financed by the Government of India wholly or in part and declared by Parliament by law to be institutions of national importance.

65. Union agencies and institutions for—

(a) professional, vocational or technical training, including the training of police officers; or

(b) the promotion of special studies or research; or

(c) scientific or technical assistance in the investigation or detection of crime.

66. Co-ordination and determination of standards in institutions for higher education or research and scientific and technical institutions.

67. Ancient and historical monuments and records, and archaeological sites and remains, declared by Parliament by law to be of national importance.

68. The Survey of India the Geological, Botanical, Zoological and Anthropological Survey of India; Meteorological organisations.

69. Census.

70. Union public services; all-India services; Union Public Service Commission.

71. Union pensions, that is to say, pensions payable by the Government of India or out of the Consolidated Fund of India.

72. Elections to Parliament, to the Legislatures of States and to the offices of President and Vice-President; the Election Commission.

73. Salaries and allowances of members of Parliament, the Chairman and Deputy Chairman of the Council of States and the Speaker and Deputy Speaker of the House of the People.

74. Powers, privileges and immunities of each House of Parliament and of the members and the committees of each House; enforcement of attendance of persons for giving evidence or producing documents before committees of Parliament or commissions appointed by Parliament.

75. Emoluments, allowances, privileges and rights in respect of leave of absence, of the President and Governors; salaries and allowances of the Ministers for the Union; the salaries, allowances and rights in respect of leave of absence and other conditions of service of the Comptroller and Auditor-General.

76. Audit of the accounts of the Union and of the States.

77. Constitution, organisation, jurisdiction and powers of the Supreme Court (including contempt of such Court) and the fees taken therein; persons entitled to practise before the Supreme Court.

78. Constitution and organisation of the High Courts except provisions as to officers and servants of High Courts; persons entitled to practise before the High Court.

79. Extension of the jurisdiction of a High Court having its principal seat in any State to, and exclusion of the jurisdiction of any such High Court from, any area outside that State.

80. Extension of the powers and jurisdiction of members of a police force belonging to any State to any area outside that State, but not so as to enable the police of one State to exercise powers

and jurisdiction in any area outside that State without the consent of the Government ot fhe State in which such area is situated; extension of the powers and jurisdiction of members of a police force belonging to any State to railway areas outside that State.

81. Inter-state migration; inter-state quarantine.

82. Taxes on income other than agricultural income.

83. Duties of customs including export duties.

84. Duties of excise on tobacco and other goods manufactured or produced in India except—

(a) alcoholic liquors for human consumption.

(b) opium, Indian hemp and other narcotic drugs and narcotics,

but including medicinal and toilet preparations containing alcohol or any substance included in sub-paragraph (b) of this entry.

85. Corporation tax.

86. Taxes on the capital value of the assets, exclusive of agricultural land, of individuals and companies; taxes on the capital companies.

87. Estate duty in respect of property other than agricultural land.

88. Duties in respect of succession to property other than agricultural land.

89. Terminal taxes on goods or passengers, carried by railway, sea or air; taxes on railway fares and freights.

90. Taxes other than stamp duties on transactions in stock exchanges and future markets.

91. Rates of stamp duty in respect of bills of exchange, cheques, promissory notes, bills of lading, letters of credit, policies of insurance, transfer of shares, debentures, proxies and receipts.

92. Taxes on the sale or purchase of newspaper and on advertisements published therein.

93. Offences against laws with respect to any of the matters in this List.

94. Inquiries, surveys and statistics for the purpose of any of the matters in this List.

95. Jurisdiction and powers of all courts, except the Supreme Court, with respect to any of the matters in this List; admiralty jurisdiction.

96. Fees in respect of any of the matters in this List, but not including fees taken in any court.

97. Any other matters not enumerated in List II or List III including any tax not mentioned in either of those Lists.

List II—State List

1. Public order (but not including the use of naval, military or air force or any other armed forces of the Union in aid of the civil power).

2. Police, including railway and village police.

3. Administration of justice; constitution and organization of all courts, except the Supreme Court and the High Court; officers and servants of the High Court; procedure in rent and revenue courts; fees taken in all courts except the Supreme Court.

4. Prisons, reformatories, Borstal institutions and other institutions of a like nature, and persons detained therein; arrangements with other States for the use of prisons and other institutions.

5. Local government, that is to say, the constitution and powers of municipal corporations, improvement trusts, district boards, mining settlement authorities and other local authorities for the purpose of local self-government or village administration.

6. Public health and sanitation; hospitals and dispensaries.

7. Pilgrimages, other than pilgrimages to places outside India.

8. Intoxicating liquors, that is to say, the production, manufacture, possession, transport, purchase and sale of intoxicating liquors.

9. Relief of the disabled and unemployable.

10. Burials and burial grounds; cremations and cremation grounds.

11. Education including universities, subject to the provisions of entries 63, 64, 65, 66 of List I and entry 25 of List III.

12. Libraries, museums and other similar institutions controlled or financed by the State; ancient and historical monuments and records other than those declared by Parliament by law to be of national importance.

13. Communications, that is to say, roads, bridges, ferries and other means of communication not specified in List I; municipal tramways; ropeways; inland waterways and traffic thereon

subject to the provisions of List I and List III with regard to such waterways; vehicles other than mechanically propelled vehicles.

14. Agriculture, including agricultural education and research, protection against pests and prevention of plant diseases.

15. Preservation, protection and improvement of stock and prevention of animal diseases; veterinary training and practice.

16. Pounds and the prevention of cattle trespass.

17. Water, that is to say, water supplies, irrigation and canals, drainage and embankments, water storage and water power subject to the provisions of entry 56 of List I.

18. Land, that is to say, rights in or over land, tenures including the relation of landlord and tenant, and the collection of rents; transfer and alienation of agricultural land; land improvement and agricultural loans; colonization.

19. Forests.

20. Protection of wild animals and birds.

21. Fisheries.

22. Courts of Wards subject to the provisions of entry 34 of List I; encumbered and attached estates.

23. Regulation of mines and mineral development subject to the provisions of List I with respect to regulation and development under the control of the Union.

24. Industries subject to the provisions of entry 52 of List I.

25. Gas and gas-works.

26. Trade and commerce within the State subject to the provisions of entry 33 of List III.

27. Production, supply and distribution of goods subjects to the provisions of entry 33 of List III.

28. Markets and fairs.

29. Weights and measures except establishment of standards.

30. Money-lending and money-lenders; relief of agricultural indebtedness.

31. Inns and inn-keepers.

32. Incorporation regulation and winding up of corporations, other than those specified in List I, and universities; un-incorporated trading, literary, scientific, religious and other societies and associations; co-operative societies.

33. Theatres and dramatic performances; cinemas subject to the provisions of entry 60 of List I; sports, entertainments and amusements.

34. Betting and gambling.

35. Works, lands and buildings vested in or in the possession of the State.

36. Acquisition or requisitioning of property, except for the purposes of the Union, subject to the provisions of entry 42 of List III.

37. Elections to the Legislature of the State subject to the provisions of any law made by Parliament.

38. Salaries and allowances of members of the Legislature of the State, of the Speaker and Deputy Speaker of the Legislative Assembly and, if there is a Legislative Council, of the Chairman and Deputy Chairman thereof.

39. Powers, privileges and immunities of the Legislative Assembly and of the members and the committees thereof, and, if there is a Legislative Council, of that Council and of the members and the committees thereof; enforcement of attendance of persons for giving evidence or producing documents before committees of the Legislature of the State.

40. Salaries and allowances of Ministers for the State.

41. State public services; State Public Service Commission.

42. State pensions, that is to say, pensions payable by the State or out of the Consolidated Fund of the State.

43. Public debt of the State.

44. Treasure trove.

45. Land revenue, including the assessment and collection of revenue, the maintenance of land records, survey for revenue purposes and records of rights and alienation of revenues.

46. Taxes on agricultural income.

47. Duties in respect of succession to agricultural land.

48. Estate duty in respect of agricultural land.

49. Taxes on lands and buildings.

50. Taxes on mineral rights subject to any limitations imposed by Parliament by law relating to mineral development.

51. Duties of excise on the following goods manufactured or produced in the State and countervailing duties at the same or

lower rates on similar goods manufactured or produced elsewhere in India :—

(a) alcoholic liquors for human consumption ;

(b) opium, Indian hemp and other narcotic drugs and narcotics ;

but not including medicinal and toilet preparations containing alcohol or any substance included in sub-paragraph (b) of this entry.

52. Taxes on the entry of goods into a local area for consumption, use or sale therein.

53. Taxes on the consumption or sale of electricity.

54. Taxes on the sale or purchase of goods other than newspapers.

55. Taxes on advertisements other than advertisements published in the newspapers.

56. Taxes on goods and passengers carried by road or on inland waterways.

57. Taxes on vehicles, whether mechanically propelled or not, suitable for use on roads, including tramcars subject to the provisions of entry 35 of List III.

58. Taxes on animals and boats.

59. Tolls.

60. Taxes on professions, trades, callings and employments.

61. Capitation taxes.

62. Taxes on luxuries, including taxes on entertainments, amusements, betting and gambling.

63. Rates of stamp duty in respect of documents other than those specified in the provisions of List I with regard to rates of stamp duty.

64. Offences against laws with respect to any of the matters in this List.

65. Jurisdiction and powers of all courts, except the Supreme Court, with respect to any of the matters in this List.

66. Fees in respect of any of the matters in this List, but not including fees taken in any court.

List III—Concurrent List

1. Criminal law, including all matters included in the Indian Penal Code at the commencement of this Constitution but exclud-

ing offences against laws with respect to any of the matters specified in List I or List II and excluding the use of naval, military or air forces or any other armed forces of the Union in aid of the civil power.

2. Criminal procedure, including all matters included in the Code of Criminal Procedure at the commencement of this Constitution.

3. Preventive detention for reasons connected with the security of a State, the maintenance of public order, or the maintenance or supplies and services essential to the community; persons subjected to such detention.

4. Removal from one State to another State of prisoners, accused persons and persons subjected to preventive detention for reasons specified in entry 3 of this List.

5. Marriage and divorce; infants and minors; adoption; wills, intestacy and succession; joint family and partition; all matters in respect of which parties in judicial proceedings were immediately before the commencement of this Constitution subject to their personal law.

6. Transfer of property other than agricultural land; registration of deeds and documents.

7. Contracts, including partnership, agency, contracts of carriage and other special forms of contracts, but not including contracts relating to agricultural land.

8. Actionable wrongs.

9. Bankruptcy and insolvency.

10. Trusts and Trustees.

11. Administrators-General and official trustees.

12. Evidence and oaths; recognition of laws, public acts and records, and judicial proceedings.

13. Civil procedure, including all matters included in the Code of Civil Procedure at the commencement of this Constitution, limitation and arbitration.

14. Contempt of court, but not including contempt of the Supreme Court.

15. Vagrancy; nomadic and migratory tribes.

16. Lunacy and mental deficiency, including places for the reception or treatment of lunatics and mental deficients.

17. Prevention of cruelty to animals.

18. Adulteration of foodstuffs and other goods.

19. Drugs and poisons, subject to the provisions of entry 59 of List I with respect to opium.

20. Economic and social planning.

21. Commercial and industrial monopolies, combines and trusts.

22. Trade Unions; industrial and labour disputes.

23. Social security and social insurance; employment and unemployment.

24. Welfare of labour including conditions of work, provident funds, employers' liability, workmen's compensation, invalidity and old age pensions and maternity benefits.

25. Vocational and technical training of labour.

26. Legal, medical and other professions.

27. Relief and rehabilitation of persons displaced from their original place of residence by reason of the setting up of the Dominions of India and Pakistan.

28. Charities and charitable institutions, charitable and religious endowments and religious institutions.

29. Prevention of the extension from one State to another of infectious or contagious diseases or pests affecting men, animals or plants.

30. Vital statistics including registration of births and deaths.

31. Ports other than those declared by or under law made by Parliament or existing law to be major ports.

32. Shipping and navigation on inland waterways as regards mechanically propelled vessels, and the rule of the road on such waterways, and the carriage of passengers and goods on inland waterways subject to the provisions of List I with respect to national waterways.

33. Trade and commerce in and the production, supply and distribution of, the products of industries where the control of such industries by the Union is declared by Parliament by law to be expedient in the public interest.

34. Price control.

35. Mechanically propelled vehicles including the principles on which taxes on such vehicles are to be levied.

36. Factories.

37. Boilers.

38. Electricity.

39. Newspapers, books and printing presses.

40. Archaeological sites and remains other than those declared by Parliament by law to be of national importance.

41. Custody, management and disposal of property (including agricultural land) declared by law to be evacuee property.

42. Principles on which compensation for property acquired or requisitioned for the purposes of the Union or of a State or for any other public purpose is to be determined, and the form and the manner in which such compensation is to be given.

43. Recovery in a State of claims in respect of taxes and other public demands, including arrears of land-revenue and sums recoverable as such arrears, arising outside that State.

44. Stamp duties other than duties or fees collected by means of judicial stamps, but not including rates of stamp duty.

45. Inquiries and statistics for the purposes of any of the matters specified in List II or List III.

46. Jurisdiction and powers of all courts, except the Supreme Court, with respect to any of the matters in this List.

47. Fees in respect of any of the matters in this List, but not including fees taken in any court.

APPENDIX IV

RECOMMENDATION OF INDIAN FINANCE COMMISSION

INTRODUCTORY

Under the Commission's recommendations, the total amount of Central grants and devolution of revenue to the State Governments will be of the order of Rs. 86 crores annually as against an average annual sum of Rs. 65 crores for the three years, 1949-50 to 1951-52.

The main recommendations of the Commission are: (a) Increase in the percentage, from 50 to 55, of the net proceeds of income-tax to be assigned to the States, (b) increase in the grants-in-aid by the Centre to Assam, Bihar, Orissa and West Bengal in lieu of their share of the export duty on jute and jute products, (c) allocation to the States of a share in certain Union excise duties, viz., tobacco, matches and vegetable products, (d) increased and additional grants to certain States which are considered by the Commission in need of assistance, (e) grants to certain less developed States for expansion of primary education.

The Commission have also laid down certain general principles to regulate grants-in-aid to States from the Centre.

Their recommendations have been accepted by the Government and necessary steps will be taken for implementing them. The Commission have suggested that except on two points, their recommendations should take effect from April 1, 1952.

The Commission consider that the resources of the State Governments should be augmented. The various memoranda submitted by the State Governments as well the discussions that the Commission had with the representatives of the States "have left us in no doubt about the imperative need for a substantial augmentation of the revenues now available" to the State Governments. "We had, however, to take into account not merely the needs of the States but the ability of the Centre as well to assist the States by the transfer of a large portion of its revenues."

In making their recommendations the Commission have kept three main considerations in view, *first* the additional transfer of

resources from the Centre must be such as the Centre could bear without undue strain on its resources, taking into account its responsibility for such vital matters as the defence of the country and the stability of its economy. *Secondly,* the principles for the distribution of grants-in-aid must be uniformly applied to all States. *Lastly,* the scheme of distribution should attempt to lessen the inequalities between States.

Allocation of Income Tax

Under Article 270 of the Constitution the Commission are required to make recommendations to the President in regard to three matters concerning income-tax, namely, (a) the percentage of the net proceeds of income-tax which may be assigned to the States, (b) the manner in which the share so assigned shall be distributed among the States, and (c) the percentage of the net proceeds of the tax which shall be deemed to represent proceeds of the tax attributable to Part C States.

At present, 50 per cent of the net proceeds of income-tax is assigned to the States. The Commission have recommended its increase to 55.

The percentage which should be deemed to represent the share of the Part C States has been fixed at 2.75.

The Commission have suggested that the States share of income-tax should be distributed as follows (all percentages): Assam 2.25 ; Bihar 9.75 ; Bombay 17.50 ; Hyderabad 4.50 ; Madhya Bharat 1.75 ; Madhya Pradesh 5.25; Madras 15.25; Mysore 2.25 ; Orissa 3.50 ; PEPSU 0.75 ; Punjab (I) 3.25 ; Rajasthan 3.50 ; Saurashtra 1.00 ; Travancore-Cochin 2.50 ; Uttar Pradesh 15.75 ; West Bengal 11.25.

There was an "almost unanimous demand" from the States for an increased share in income-tax. While it is undesirable to concentrate on income-tax as a balancing factor in the adjustment of resources between the Centre and the units, nevertheless, on a consideration of various factors, they feel that some increase in the share assignable to the States is justified.

The Commission analyse exhaustively the claims advanced by the States for an increased share of income-tax and the bases suggested for its distribution and come to the conclusion that the following should be the main considerations in determining

distribution of income-tax: (a) A general measure of needs, furnished by population; and (b) contribution.

On a broad view of the position the Commission propose that 20 per cent. of the States' share of the divisible pool of income-tax should be distributed among the States on the basis of the relative collections of States and 80 per cent on the basis of their relative population according to the census of 1951. Applying this formula to the collections during the three years beginning March 1951 with certain adjustments for the Part B States, the Commission have recommended the percentage mentioned earlier.

In making the allocation to the States, the Commission have taken into account the population and collections of the "merged areas" (former Indian States) included in the various Part A States. As these States will be receiving their share of divisible taxes on a common basis with all the other States, the Commission have suggested that "the revenue gap grants" which the States of Bihar, Bombay, Madhya Pradesh and West Bengal are now receiving in respect of "merged areas" should be discontinued with effect from April 1, 1952. Part B States will however receive their share of revenue or the guaranteed revenue gap grants whichever is more.

As part of their scheme of assistance the Commission have made certain specific recommendations for distributing duties. These recommendations can be implemented only when the necessary legislation is enacted by Parliament.

Distribution of Union excise duties was not specifically included in the Commission's terms of reference but they were convinced that it was open to them to suggest such distribution as part of their plan of assistance. A number of State Governments had raised this claim.

The Commission, however, do not consider it desirable, at any rate for the present, to distribute, all Union excise duties. Three such items—tobacco, including cigarettes, cigars, etc., matches and vegetable products—are considered by the Commission most suitable for distribution. It has been recommended that 40 per cent of the net proceeds of these duties should be allocated to the States and distribution among them should be made in proportion to their population. The shares of the individual States

will be (percentages) : Assam 2.61 ; Bihar 11.60 ; Bombay 10.37 ; Hyderabad 5.39 ; Madhya Bharat 2.29 ; Madhya Pradesh 6.13 ; Madras 16.44 ; Mysore 2.62 ; Orissa 4.22 ; PEPSU 1.00 ; Punjab (I) 3.66 ; Rajasthan 4.41 ; Saurashtra 1.19 ; Travancore-Cochin 2.68 ; Uttar Pradesh 18.23 ; West Bengal 7.16.

As a corollary to this recommendations the Commission suggest that the present arrangement whereby certain States (Bombay, Madras and Madhya Pradesh) do not levy taxes on tobacco and receive in lieu some compensation from the Centre, should be discontinued with effect from April 1, 1953. The States concerned should be left free to levy such taxes as they like.

Action to promote the necessary legislation for the implementation of these recommendations should be taken at the earliest possible date and legislation should be given effect from April 1, 1952.

Under the Government of India Act 1935, 62½ per cent of the net proceeds of the export duty on jute and jute products were allocated to the jute-growing provinces. After partition, which resulted in considerable parts of the jute-growing areas of undivided India being included in Pakistan, the share was reduced to 20 per cent. The Expert Committee on Financial Provisions of the Union Constitution suggested that the export duty should not be shared but grants-in-aid should be given to the provinces in lieu of the duty for a transitional period.

Under Article 273 of the Constitution grants-in-aid have to be paid for a transitional period to Assam, Bihar, Orissa and West Bengal in lieu of their share of the export duty on jute and jute products. The Deshmukh Award fixed the grants-in-aid to the concerned States at : West Bengal Rs. 105 lakhs, Assam Rs. 40 lakhs, Bihar Rs. 35 lakhs and Orissa Rs. 5 lakhs. Under the Commission's recommendations the grants-in-aid will be : West Bengal Rs. 150 lakhs, Assam Rs. 75 lakhs, Bihar Rs. 75 lakhs and Orissa Rs. 15 lakhs.

The Commission suggest that these grants-in-aid should be paid to the States with effect from 1952-53.

Important recommendations have been made on the principles that should govern grants-in-aid by the Centre. The Com-

mission analyse the various reasons for which grants-in-aid are made including (a) the deficiency of States' resources, (b) importance of augmenting welfare services and development projects, and (c) developing some activities like those to solve unemployment, insurance, social security, etc., and other factors. Historically speaking, the most important factor governing grants-in-aid has been the deficient resources of the States "at a time when the impact of a rapidly changing economic situation created large and insistent demands for new Governmental services."

Both conditional and unconditional grants have their place. Unconditional grants should reinforce the general resources of the State Governments which would be free to allocate such grants among competing purposes according to their best judgment, subject to the usual administrative and Parliamentary checks. Conditional grants—which may be for broad purposes—may be given to stimulate expansion of particular categories of services rather than specific schemes under those categories.

Discussing the principles under which grants-in-aid should be made, the most important criterion that the Commission prescribe is the extent of self-help that a State practises. This should determine the eligibility for, as well as the amount of, help from the Centre. *Secondly,* the method of extending financial assistance should be such as to avoid any suggestion that the Central Government have taken upon themselves the responsibility for helping the States to balance their budgets from year to year.

Economy in expenditure practised by the States is another test recommended. Other principles suggested are : (a) Grants-in-aid should assist in equalizing standards of basic social services. Factors like the area of a State in relation to its population, economic backwardness, etc., would be reflected in the level of social services and the standard of development of a State and these should be taken into account; (b) a State may be helped to meet the special burden or obligations of national concern, though they may arise within the State's sphere, for example, the strain on the economy and the administration of the State as a consequence of partition, increased responsibility in respect of security, etc. ; and (c) beneficient services of primary importance for which assistance to less advanced States is in the national interest.

These principles had been kept in view by the Commission while formulating their recommendations.

General grants to individual States have also been recommended after considering the financial position of the States and taking into account the increased resources that would be available to them as a result of the Commission's recommendations for the allocation of revenues. The Commission consider that Madras, Uttar Pradesh, Bihar, Madhya Pradesh, Hyderabad, Rajasthan, Madhya Bharat and PEPSU are not in need of further assistance Bombay, West Bengal, Orissa and Saurashtra are treated as "marginal cases," while Punjab (I) and Assam as definitely in need of assistance. For Mysore and Travancore-Cochin the Commission recommend Central assistance mainly with a view to helping them maintain their progress.

Among the States which are "marginal cases" the Commission have recommended no additional assistance for Bombay taking into account the well-developed economy of the State, the size of its Budget and the resilience of its resources. The proposed withdrawal of the present restriction on taxing tobacco will also leave the State free to raise additional revenue from this source.

For West Bengal, a grant-in-aid of Rs. 80 lakhs has been recommended having regard to its problems arising from partition and the continuous movement of displaced persons from East Pakistan. For Orissa, the present grant-in-aid of Rs. 40 lakhs is raised to Rs. 75 lakhs to give it a margin for further development. Orissa has relatively backward territory in its merged areas and a substantial element of scheduled tribes and other backward classes in its population.

In the case of Saurashtra the grant-in-aid recommended is Rs. 40 lakhs and for Punjab (I) Rs. 1.25 crores. The Commission consider that the allocation of revenue recommended by them will not meet Punjab (I)'s budgetary needs, much less leave any margin for development. The State has also assumed additional responsibilities on account of partition.

For Assam, the present grant-in-aid of Rs. 30 lakhs will be raised to Rs. 1 crore. For Mysore and Travancore-Cochin grants-in-aid recommended are Rs. 40 lakhs (for Mysore) and Rs. 45

lakhs (for Travancore-Cochin) mainly with a view to helping them in maintaining their progress.

Three States, Saurashtra, Mysore and Travancore-Cochin, do not benefit from the increased devolution of revenue suggested by the Commission and their revenue gap grants are likely to be higher than their share of revenue.

In the case of Assam, West Bengal and Punjab (I), the Commission have assumed that the expenditure on relief and rehabilitation of displaced persons will continue to be borne mainly by the Centre and that no appreciable additional burden will be placed upon these States on this account.

The Commission have made a new departure in the pattern of general grants-in-aid to the States; special grants-in-aid have been recommended for expansion of primary education in some States the need for which became apparent during their discussions with the Governments concerned. They have suggested a "modest beginning" in this direction by helping those States where a large leeway has to be made up. The following States in which primary education is at present comparatively backward have been recommended assistance in the next four years on a gradually rising scale (in lakhs of rupees):

		1953-54	1954-55	1955-56	1956-57
Bihar	..	41	55	69	83
Madhya Pradesh	..	25	33	42	50
Hyderabad	..	20	27	33	40
Rajasthan	..	20	26	33	40
Orissa	..	16	22	27	32
Punjab	..	14	19	23	28
Madhya Bharat	..	9	12	15	18
PEPSU	..	5	6	8	9

Under all the recommendations made by the Finance Commission, this is what each State might expect to receive annually (the figures in brackets show average amounts received under the Deshmukh Award, which was in force till the end of 1951-52):

		Rs.	Rs.
Assam	..	3.45 crores	(2.21 crores)
Bihar	..	8.55 crores	(6.55 crores)
Bombay	..	11.25 crores	(11.60 crores)
Hyderabad	..	3.59 crores	(1.25 crores)
Madhya Bharat	..	1.46 crores	(6 lakhs)
Madhya Pradesh	..	4.20 crores	(3.35 crores)
Madras	..	11.10 crores	(8.56 crores)
Mysore	..	3.68 crores	(3.45 crores)

		Rs.	Rs.
Orissa	..	3.74 crores	(2.01 crores)
PEPSU	..	65 lakhs	(16 lakhs)
Punjab	..	3.82 crores	(3.43 crores)
Rajasthan	..	2.89 crores	(10 lakhs)
Saurashtra	..	3.02 crores	(2.75 crores)
Travancore-Cochin	..	3.23 crores	(3.22 crores)
Uttar Pradesh	..	11.70 crores	(8.88 crores)
West Bengal	..	9.60 crores	(7.54 crores)

The amounts received till 1951-52 are average for three years in the case of Part A States and for two years in the case of Part B States.

The actual sums accruing by way of devolution of revenue will obviously vary from year to year. The above is only by way of indication of the order of sums likely to be received under the Finance Commission's scheme on the present estimates of the yield from the divisible taxes.

The Commission have assumed that their recommendations, if given effect to, would be operative for a period of five years ending March 31, 1957.

Arrears of Income-Tax Shares

In addition to the share of revenues under the Commission's scheme the States will receive the outstanding arrears of their share of income-tax in respect of the period before April 1, 1952. The Budget for 1952-53 assumes that these arrears will be Rs. 5 crores and, if the actual amount is of this order, Madras will receive Rs. 87 lakhs, Bombay Rs. 105 lakhs, West Bengal Rs. 68 lakhs, Uttar Pradesh Rs. 90 lakhs, Punjab (I) Rs. 27 lakhs, Bihar Rs. 63 lakhs, Madhya Pradesh Rs. 30 lakhs, Assam Rs. 15 lakhs, and Orissa Rs. 15 lakhs.

The Commission have made two further recommendations, one relating to the setting up a small organization to study State finances and the other for improving the available statistics in regard to income-tax. This organization, the Commission suggest, should preferably be a part of the Secretariat of the President, and make a continuous study of the finances of the State Governments so that whenever future Finance Commissions are constituted they will have sufficient material available to them at the very commencement of their inquiry. It should work in close liaison with the Finance Ministry.

BIBLIOGRAPHY

1. Books and Works of Reference

Adarkar, P. B. .. *The Principles and Problems of Federal Finance,* 1933.

Ambedkar, B. R. .. *The Evolution of Provincial Finance in British India,* 1925.

Anstey, Vera .. *The Economic Development of India.* 3rd edition, 1936.

Appadorai, A. .. *Dyarchy in Practice,* 1937.

Baden-Powell, B. H. .. *Land Revenue in British India,* 1913.

Banerjee, P. .. *Provincial Finance in India,* 1929.

Bastable, C. F. .. *Public Finance,* 1903.

Benham, F. C. .. *The Prosperity of Australia,* 1930.
Economics, 1938.

Bentham, Jeremy .. *County Courts—A Protest Against Law Taxes.* London, 1853.

Blunt, Sir Edward .. *The I.C.S.,* 1937.
Social Services in India. (Editor), 1939.

Cannan, Edwin .. *History of Local Rates in England,* 1912.

Catlin, George Edward Gordon .. *Liquor Control,* 1931.

Chand, Gyan .. *The Essentials of Federal Finance,* 1929.
The Financial System of India, 1926.

Dalton, Hugh .. *Public Finance,* 1936.
Unbalanced Budgets. (Editor), 1934.

Darling, M. L. .. *The Punjab Peasant in Prosperity and Debt,* 1932.

De Viti, Antonio, de Marco .. *First Principles of Public Finance,* 1936.

Finer, Hermann .. *English Local Gopernment,* 1933.

Gangulee, G. N. .. *The Making of Federal India,* 1936.

Grice, James Watson .. *National and Local Finance,* 1910.

Hicks, U. K. .. *The Finance of British Government,* 1938.
Public Finance.
Public Finance (India) U. N. Survey.

HILTON-YOUNG, E. .. *The System of National Finance*, 1936.

HOBSON, J. A. .. *Taxation in the New State*, 1919.

HOWARD, A. .. *Crop Production in India*, 1924.

KNOWLES, L. C. A. .. *Economic Development of the Overseas Empire*, 1928.

LUTZ, H. L. .. *Public Finance*, 1936.

MARSHALL, ALFRED .. *Nation Taxation after the War*. This forms chapter xviii in *After War Problems*, edited by William Harbutt Dawson, 1917.

MILL, JOHN STUART .. *Principles of Political Economy*.

MULLA, D. F. .. *Principles of Hindu Law*, 1936.

MISRA, B. R. .. *Economic Aspects of the Indian Constitution*, 1952.

PIGOU, A. C. .. *The Economics of Welfare*, 1929.
A Study of Public Finance, 1929.

SELIGMAN, E. R. A. .. *Essays in Taxation*, 1925.
Studies in Public Finance, 1925.
Progressive Taxation in Theory and Practice, 1908.

SHAH, K. T. .. *Sixty Years of Indian Finance*, 1921.

SHAH, K. T. AND KHAMBATTA, K. J. .. *Wealth and Taxable Capacity of India*, 1924.

SHIRRAS, G. FINDLAY .. *Science of Public Finance*, 2 vols., 1936.

SMITH, ADAM .. *The Wealth of Nations*. Cannan's edition, 1930.

STAMP, LORD .. *The Fundamental Principles of Taxation*, 1936.
Wealth and Taxable Capacity, 1922.

STRACHEY, SIR JOHN AND LT.-GEN. RICHARD .. *The Finances and Public Works of India*, 1882.

THOMAS, P. J. .. *The Growth of Federal Finance in India*, 1939.

VAKIL, C. N. .. *Financial Development in Modern India*, 1924.

VAKIL, C. N. AND PATEL, M. H. .. *Finance under Provincial Autonomy*, 1940.

WARBURTON, CLARK .. *The Economic Results of Prohibition*, 1932.

WEBB, SIDNEY .. *Grants-in-Aid*, 1920.

INDEX